Competence and capabilities includes consideration of:

- Practical experience
- Understanding of professional standards
- Expertise in specialised areas of accounting and auditing
- Expertise in IT or automated tools and techniques
- Knowledge of relevant industries
- Ability to exercise professional scepticism and judgement
- Understanding of the firm's policies and procedures

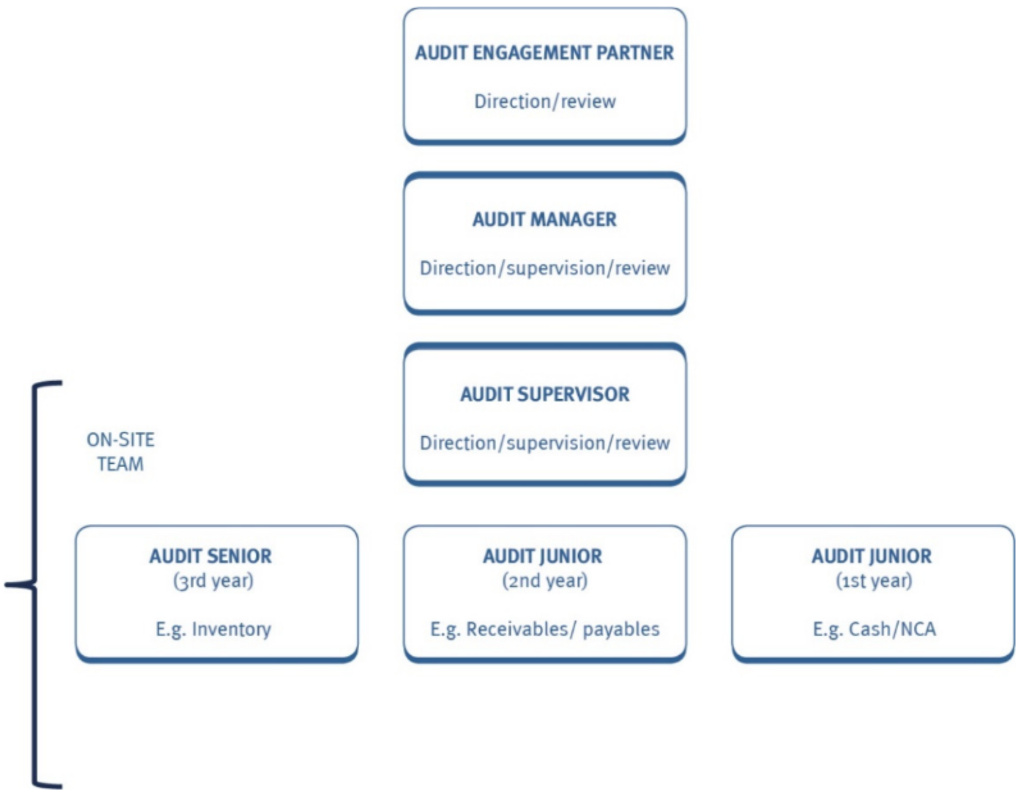
[ISA 220 (Revised), A71]

If insufficient resources are made available the following actions can be taken:

- Change the planned audit approach
- Arrange an extension to the reporting deadline
- Follow the firm's policies and procedures for resolving differences of opinion
- Withdraw from the engagement if possible under applicable law or regulation.

[ISA 220 (Revised), A78]

Composition of the audit team



Technological resources

Technological resources include technology to conduct meetings, communication and automated tools and techniques. The auditor must be careful not to place too much reliance on those resources.
[ISA 220 (Revised), A63]

Intellectual resources

Intellectual resources include audit methodologies, implementation tools, auditing guides, templates and checklists. These allow for consistent application and understanding of professional standards.
[ISA 220 (Revised), A68, A69]

Engagement performance

Engagement performance comprises direction, supervision and review of the engagement.

Direction involves informing team members of their responsibility to:

- Contribute to the management and achievement of quality of the engagement.
- Maintain a questioning mind and exercise professional scepticism.
- Fulfil ethical requirements.

- Perform audit procedures and for more experienced team members to direct, supervise and review the work of less experienced team members.
- Understand the objectives of the work to be performed.
- Address threats to the achievement of quality e.g. budget or resource constraints should not result in team members failing to perform planned audit procedures.

[ISA 220 (Revised), A85]

Supervision includes:

- Tracking the progress of the audit to ensure the objective of the work is achieved and adequate ongoing resources are assigned.
- Addressing issues arising and modifying the planned approach accordingly e.g. by reassigning planned procedures to more experienced team members when issues are more complex than initially anticipated.
- Identifying matters for consultation. Consultation may be required where the firm lacks appropriate internal expertise.
- Providing coaching to help develop skills and competencies.
- Creating an environment where engagement team members can raise concerns without fear of reprisal.

[ISA 220 (Revised), A86]

e.g

Supervision during the audit

The audit of Fast Cars Co is currently taking place. The audit team comprises the audit supervisor and two audit juniors.

One of the audit juniors has only recently joined the firm and has no previous audit experience, therefore the audit supervisor has been providing on-the-job coaching, including explaining the objective and purpose of the procedures to be performed and the importance of directional testing when testing specific assertions. The supervisor is also available for questions from both audit juniors.

Due to client staff not being available, there have been difficulties obtaining audit evidence and the audit work is behind schedule. The audit supervisor believes it will be difficult to complete the audit work by the agreed deadline and has therefore arranged for additional resource to help complete the outstanding work and a recently promoted supervisor has been assigned to the team.

During the audit it has been identified that the audit of receivables, which was originally assigned to one of the audit juniors, is higher risk than anticipated at the planning stage and this section has now been reassigned to the additional supervisor.

Review responsibilities include consideration of whether:

- The work has been performed in accordance with professional standards, policies and procedures
- Appropriate consultations have taken place
- The work performed supports the conclusions reached
- The evidence obtained is sufficient and appropriate to support the auditor's report
- The objectives of the engagement procedures have been achieved.

[ISA 220 (Revised), A88]

The engagement partner must review audit documentation at appropriate points during the engagement including documentation of significant matters, significant judgements and other matters relevant to the engagement partner's responsibilities. [ISA 220 (Revised), 31]

Engagement quality review

An engagement quality review (EQR) is an objective evaluation of the significant judgements made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report. [ISQM 2 *Engagement Quality Reviews*, 13a]

An engagement quality reviewer is a partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review. [ISQM 2, 13b]

Listed entities and other high-risk clients should be subject to an engagement quality review. High risk clients include those which are in the public interest, those with unusual circumstances and risks, and those where laws or regulations require an EQR.

[ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, 34f]

For audit engagements where an EQR is required, the engagement partner must:

- Determine that an EQR has been appointed.
- Cooperate with the reviewer and inform other team members of their responsibility to do so.
- Discuss significant matters and significant judgements arising during the engagement with the reviewer.
- Not date the auditor's report until the completion of the EQR.

[ISA 220 (Revised), 36]

Eligibility of Engagement Quality Reviewers:

- Cannot be a member of the engagement team.
- Must have the competence and capabilities, including sufficient time, and the appropriate authority to perform the EQR.
- Must comply with relevant ethical requirements and laws and regulations.

[ISQM 2, 18]

Monitoring and remediation

A monitoring and remediation process must be established to provide relevant, reliable and timely information about the design, implementation and operation of the system of quality management and take appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis. [ISQM 1, 35]

In order to achieve this the firm must:

- Establish quality objectives
- Identify and assess quality risks
- Design and implement responses to address quality risks.

[ISQM 1, 23]

The firm must monitor the system as a whole by inspecting completed engagements selected according to risk and taking consideration of other monitoring activities performed by the firm. [ISQM 1, 38]

The firm must evaluate the severity of deficiencies and investigate the root cause of the deficiencies, evaluating the effect on the quality management system. [ISQM 1, 41]

The firm should then appropriately remediate deficiencies responsive to the root cause. [ISQM 1, 42]

Remedial actions may include bringing in an auditor's expert or enhancing the nature, timing and extent of direction, supervision and review where deficiencies have been identified. If a deficiency does not affect the quality of the audit (e.g. if a technological resource that was available was not used) no further action is required. [ISA 220 (Revised), A111]

However, even if a deficiency is identified, it does not necessarily mean that audit quality has been affected or that the report issued was inappropriate.

Annual evaluation of the firm's quality management system is required to be undertaken. [ISQM 1, 9]

	Post-issuance reviews
Purpose	To assess whether the firm's policies and procedures were implemented during an engagement and to identify any deficiencies therein.
When	After the auditor's report has been signed.
Which files	A selection of completed audit files.
Conducted by	A dedicated compliance or quality department/a qualified external consultant/an independent partner.
Matters considered	Working papers should demonstrate that: • Sufficient appropriate evidence has been obtained. • All matters were resolved before issuing the auditor's report. All working papers should be: • On file • Completed • Signed as completed • Evidence as reviewed.
Outcomes	A report of the results will be provided to the partners of the firm highlighting deficiencies that require corrective action. Recommendations will be made including: • Communication of findings • Additional quality reviews • Training • Changes to the firm's policies and procedures • Disciplinary action.

Note: ISQMs are not examinable for this exam, however, awareness of engagement quality reviews and reviewers is useful in terms of ethical safeguards and quality management measures. Therefore, detailed knowledge is not required and the references above are included to enhance your overall understanding.

Evaluating quality management deficiencies

A post-issuance quality review is being performed for the audit of Button Co. During the review the following deficiencies have been identified:

1 No briefing meeting was held at the planning stage for the audit team. Instead, the audit supervisor spoke to each team member individually to inform them of their role and responsibilities.

2 The audit supervisor was unable to work for one week of the audit due to sickness. No replacement was arranged resulting in the audit juniors being unsupervised for this time.

3 The audit team's work was only reviewed by the audit manager three days prior to the date the auditor's report was signed rather than being reviewed at regular intervals during the audit.

The first deficiency means the audit has not been performed as efficiently as it could have been as the audit supervisor could have briefed the whole team in one meeting rather than speaking to each person individually. Assuming each person received the relevant information, this will not have impacted audit quality.

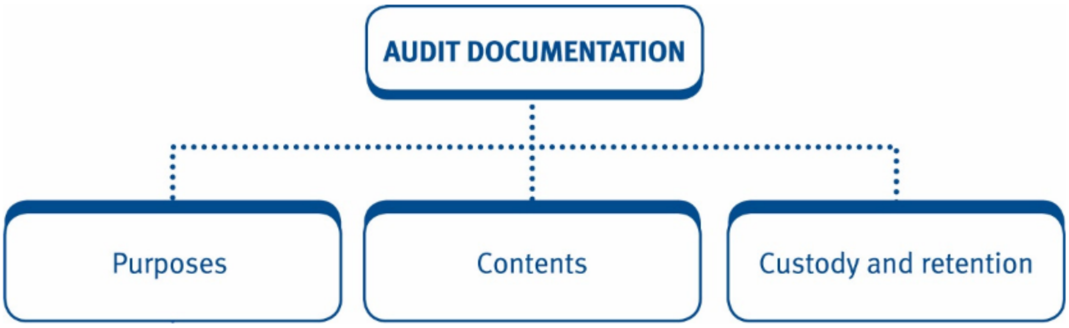
The second deficiency potentially has more severe consequences depending on the complexity of the audit and the experience of the audit juniors. If the audit was complex and/or the audit juniors relatively inexperienced, if issues were identified, there was no-one for them to raise concerns with and no-one keeping track of the competence of the team or tracking the progress of the audit. This could have caused problems with audit quality. However, if the audit was straightforward with no issues being encountered and the audit juniors were able to carry out their work without the need to ask for help, there may have been no quality issues.

The third deficiency potentially has severe consequences, particularly when coupled with the lack of supervision. If the review of work identified that further work needed to be performed, the fact that the review took place so late in the audit process could have meant not enough time was available to do this additional work. This could have meant sufficient and appropriate evidence was not obtained. However, if the audit was straightforward and no further work was required to be performed, audit quality will not have been affected.

The key message is that without quality management processes in place, audits may not be performed to the required standard.

In respect of the above, the deficiencies need to be remediated by communicating the need for appropriate direction, supervision and review with managers and partners. Additional quality reviews should be performed to ensure this feedback is being actioned.

8 Audit documentation



Purposes of audit documentation

ISA 230 *Audit Documentation* requires auditors to prepare and retain written documentation that:

- Provides evidence of the auditor's basis for their report.
- Provides evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

[ISA 230, 2]

In addition, audit documentation:

- Assists the engagement team to plan and perform the audit.
- Assists members of the engagement team responsible for supervision to direct, supervise and review the audit work.
- Enables the engagement team to be accountable for its work.
- Retains a record of matters of continuing significance to future audits.
- Enables engagement quality reviews and monitoring activities under the firm's system of quality management to be performed.
- Enables the external quality inspections to be performed.

[ISA 230, 3]

Form and content of audit documentation

Documentation should be sufficient to enable an experienced auditor, with no previous connection to the audit, to understand:

- The nature, timing and extent of audit procedures performed.
- The results of the procedures performed and the evidence obtained.
- The significant matters arising during the course of the audit and the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

[ISA 230, 8]

Retention of working papers

Documentation is retained in an audit file, which should be completed in a timely fashion after the date of the auditor's report (normally not more than 60 days after) and retained for the period required by national regulatory requirements (this is normally five years from the date of the auditor's report).

[ISA 230, A21, A23]

Illustration 1 – Wimble & Co working paper

Client:	Murray Co	Reference:	RA1
Period end:	31/12/X4	Prepared by:	Rob Cash
Subject	Risk Assessment	Date prepared:	Dec 1 20X4

Objective:	To identify the risks of material misstatement in the financial statements of Murray Co for the year ended 31 December 20X4, in order to provide a basis for designing and performing audit procedures that respond to the assessed risks.
Work performed:	Discussion among the engagement team of the susceptibility of the financial statements to material misstatement: RA1/1of the financial statements to material misstatement: **RA1/1** A summary of the understanding of the entity and its environment obtained, detailing the key elements including internal control components, sources of information and risk assessment procedures performed: **RA/2** Analytical procedures performed: **RA/3**
Results:	The identified and assessed risks of material misstatement: **RA/4**
Conclusions:	The overall responses to address the risks of material misstatement: **RA/5**
Reviewed by:	An Audit Manager
Date reviewed:	December 5 20X4

Wimble & Co working paper

Features of Wimble & Co working paper

Name of client: identifies the client being audited.

Period-end date: identifies the period to which the audit work relates.

Subject: identifies the topic of the working paper such as the area of the financial statements being audited, or the overall purpose of the work.

Working paper reference: provides a clear reference to identify the working paper. RA1 is the first working paper in the risk assessment section.

Preparer: identifies the name of the audit team member who prepared the working paper to enable any queries to be directed to the relevant person.

Date prepared: the date the audit work was performed, the end of the time period to which issues were considered.

Objective: this explains the relevance of the work being performed (in relation to financial statement assertions where appropriate).

Work performed: the work done cross-referenced to supporting working papers, including details of the sources of information, and items selected for testing (where relevant).

Results of work performed: any significant issues identified, exceptions or other significant observations including whether further audit work is necessary.

Conclusions: key points (including whether the area is true and fair where relevant).

Reviewer: the name of the audit team member who reviewed the work. This provides evidence of the review as required by ISA 220 (Revised).

Date of review: this must be before the audit opinion is signed.

Types of audit documentation

Audit documentation includes:

- Planning documentation
  - overall audit strategy
  - audit plan
- Audit programmes
- Summary of significant matters
- Written representation from management
- Checklists
- Correspondence
- Copies of client records.

Example contents of a permanent audit file

For large audits, much of the knowledge of the business information may be kept on a **permanent file** and the audit plan may contain a summary or simply cross reference to the permanent file. Typical information on a permanent file includes:

- Names of management, those charged with governance, shareholders
- Systems information
- Background to the industry and the client's business
- Title deeds
- Directors' service agreements
- Copies of contract and agreements.

Example contents of a current audit file

The audit work for a specific period is kept on a **current file**.

Typically, there are at least three sections:

- Planning
- Performance
- Completion.

Planning

The main element of this section is likely to be the Audit Planning Memorandum.

This document is the written audit plan and will be read by all members of the audit team before work starts. Its contents are likely to include:

- Background information about the client, including recent performance
- Changes since last year's audit (for recurring clients)
- Key accounting policies
- Important laws and regulations affecting the company
- Trial balance (or draft financial statements)
- Preliminary analytical procedures
- Key audit risks
- Overall audit strategy
- Materiality assessment
- Timetable of procedures
- Deadlines
- Staffing and a budget (hours to be worked × charge out rates)
- Locations to be visited.

Performance

Working papers are likely to consist of:

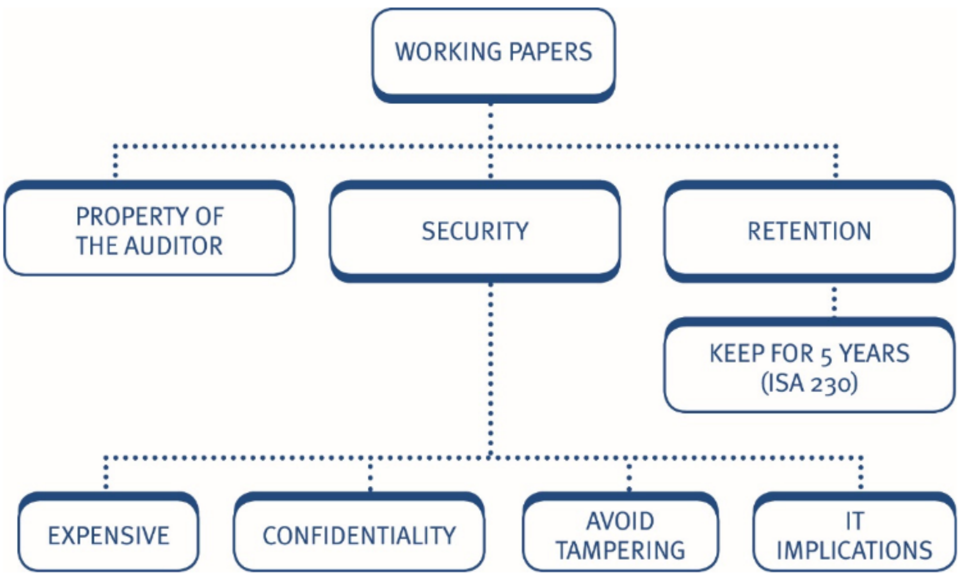
- Lead schedule – showing total figures, which agree to the financial statements.
- Back-up schedules – breakdowns of totals into relevant sub-totals.
- Audit work programme detailing:
  - The objectives being tested
  - Work completed
  - How samples were selected
  - Conclusions drawn
  - Who did the work
  - Date the work was completed
  - By whom it was reviewed.

Completion

The completion (also known as review) stage of an audit has a number of standard components:

- Going concern review
- Subsequent events review
- Final analytical procedures
- Accounting standards (disclosure) checklist
- Written representation from management
- Summary of adjustments made since trial balance produced
- Summary of unadjusted misstatements
- Draft final financial statements
- Draft report to those charged with governance and management letter.

Security of working papers



Who owns the working papers?

The auditor owns the audit working papers. This is important because:

- Access to the working papers is controlled by the auditor, not the client, which is an element in preserving the auditor's independence.
- In some circumstances care may need to be taken when copies of client generated schedules are incorporated into the file.

Security

Working papers must be kept secure.

- By its nature, audit evidence will comprise confidential, sensitive information. If the files are lost or stolen, the auditor's duty of confidentiality will be compromised.
- Audits are expensive. If the files are lost or stolen, the evidence they contain will need to be recreated, so the work will need to be done again. The auditors may be able to recover the costs from their insurers, but otherwise it will simply represent a loss to the firm.
- There have been cases of unscrupulous clients altering auditors' working papers to conceal frauds.

The implications of IT-based audit systems are also far reaching.

- By their nature, laptops are susceptible to theft, even though the thief may have no interest in the contents of the audit file. Nevertheless, all the problems associated with re-performing the audit and breaches of confidentiality remain.
- It is more difficult to be certain who created or amended computer based files than manual files – handwriting, signatures and dates have their uses – and this makes it harder to detect whether the files have been tampered with.

This means that the following precautions need to be taken.

- If files are left unattended at clients' premises – overnight or during lunch breaks – they should be securely locked away, or if this is not possible, taken home by the audit team.
- When files are left in a car, the same precautions should be taken as with any valuables.
- IT-based systems should be subject to passwords, encryption and back up procedures.

Test your understanding 1

It is 1 July 20X5. You have recently been assigned as audit senior for the audit of Rock Co for the year ending 31 August 20X5. Your firm has audited this company for a number of years but this is the first year you will have worked on this audit.

Rock Co is a company listed on a stock exchange. Rock Co is engaged in the wholesale import, manufacture and distribution of basic cosmetics and toiletries for sale to a wide range of stores, under a variety of different brand names.

Required:

(a) **Describe the procedures you will perform in order to obtain an understanding of Rock Co.**

(10 marks)

(b) You are now nearing the completion of the audit of Rock Co. You have been asked to perform a review of the audit file before it is passed to the audit manager and the audit engagement partner for their review. You have been asked to concentrate on the proper completion of the audit working papers. Some of the audit working papers have been produced electronically but all of them have been printed out for you.

Required:

Describe the types of audit working papers you should expect to see in the audit file and the features of those working papers that show that they have been properly completed.

(10 marks)

(Total: 20 marks)

Test your understanding 2

You are the audit manager responsible for planning the audit of Rottnest Co. During the planning of the audit you have identified an increased risk of material misstatement due to fraud. The audit strategy and audit plan reflect this increased risk.

1 **Which of the following statements regarding fraud is TRUE?**

A The auditor may not detect all material fraud in the financial statements but this won't necessarily mean the auditor has been negligent due to the nature of fraud and the likelihood of concealment

B The auditor must detect all material fraud in the financial statements

C The auditor must detect every fraud in the financial statements

D The auditor is not responsible for detecting fraud as this is management's responsibility

2 **If material misstatement as a result of fraud is detected during the audit, and is not corrected by management, how will this be communicated to the shareholders?**

A The auditor must send a letter to the shareholders informing them of the fraud

B The auditor must speak at the annual general meeting and specifically inform them

C The auditor will report it to the police and the police will notify the shareholders

D Through the auditor's report as the opinion will be modified

3 **Which of the following procedures must the auditor perform to respond to the risk of fraud?**

(i) The auditor must obtain written representation from management confirming they have disclosed all known and suspected frauds to the auditor.

(ii) The auditor must incorporate an unpredictable element into the design of their audit procedures.

(iii) The auditor must test year-end journal entries and estimates which may be used to manipulate the financial statements.

A (i) and (ii) only

B (i) and (iii) only

C (ii) and (iii) only

D (i), (ii) and (iii)

4 **Which of the following statements is TRUE in respect of the audit plan?**

A The audit plan sets out the scope, direction and framework for the audit

B The audit plan contains the detailed audit procedures designed to obtain sufficient appropriate evidence including the objective of each procedure and the sample size to be tested

C The plan includes preliminary engagement activities such as materiality and risk assessment

D The audit plan is developed before the audit strategy

5 **Which matters will NOT be included in the audit strategy?**

A Risk assessment and materiality

B Communications with the client

C Specific audit procedures to respond to the risks assessed

D The need for professional scepticism

Test your understanding 3

Your firm has recently been appointed auditor of Albany Co, a large company with sophisticated computer systems. The planning is due to commence shortly. It has been agreed with the client that an interim and final audit will be performed.

1 **Which of the following is NOT a benefit of planning the audit?**

A It ensures the audit is performed efficiently and effectively

B It helps identify the resources to be allocated

C It ensures the financial statements will be correct

D It minimises the risk of issuing an inappropriate audit opinion

2 **Which of the following is NOT part of the planning stage of the audit?**

A Preliminary materiality assessment

B Risk assessment

C Developing the audit strategy

D Final analytical procedures

3 **Which of the following is the most appropriate time to perform an interim audit?**

A After the year end before the auditor's report is signed

B Before the year end

C At the same time as the final audit

D After the auditor's report has been signed

4 **Which of the following will NOT be performed at the interim audit?**

A Obtaining written representation from management

B Tests of controls

C Transaction testing for transactions that have occurred to date

D Performing risk assessment procedures

5 **What are the main reasons for performing an interim audit?**

(i) To increase fee income for the firm.

(ii) To reduce time pressure at the final audit.

(iii) To assess the level of control risk and determine the amount of substantive testing required at the final audit.

A (i) and (ii) only

B (i) and (iii) only

C (ii) and (iii) only

D (i), (ii) and (iii)

Test your understanding 4

It is 1 July 20X5. Tasmania & Co is a firm of chartered certified accountants offering a range of audit and other assurance engagements.

The firm has recently been appointed auditor of Fraser Co which has been assessed as a high risk engagement. Planning of the audit for the year ending 30 September 20X5 is due to commence next week with a planning meeting with the client to obtain an understanding of the business and its performance during the year to date, followed by a meeting of the audit team members.

As it is a high risk engagement, an engagement quality review will need to be performed and a reviewer has yet to be assigned. The firm has six partners. Detail of their partner level experience and current utilisation is shown below.

	Partner level experience	**Utilisation rate**
JK	Less than 1 year	75%
LM	6 years	80%
NO	10 years	75%
PQ	12 years	100%
RS	15 years	100%
YZ	20 years	95%

Additional information:

LM has been assigned as the audit engagement partner for Fraser Co.

YZ is due to move to a part time role from 1 October 20X5.

1 **Which of the following is NOT one of the eight categories of a quality management system as per ISA 220 (Revised)?**

A Engagement resources

B Engagement performance

C Engagement quality review

D Monitoring and remediation

2 **Which of the following are primary reasons why a firm should perform audits to a high standard of quality?**

(i) To maintain confidence in the audit profession.

(ii) To ensure auditor's reports issued are appropriate.

(iii) To avoid punishment.

(iv) To ensure clients receive a competent and professional service.

A (i) and (ii)

B (i), (iii) and (iv)

C (iii) and (iv)

D (i), (ii) and (iv)

3 **The planning meeting of audit team members is an example of which element of quality management?**

A Direction

B Consultation

C Review

D Supervision

4 **Which partner should be assigned as the Engagement Quality Reviewer?**

A JK

B NO

C PQ or RS

D YZ

5 **Which of the following statements regarding quality management is FALSE?**

A Where deficiencies in quality management procedures are identified the firm should take action such as providing additional training or increasing the frequency of quality reviews.

B The firm only needs to act on deficiencies identified by an external quality review such as that performed by the ACCA.

C The firm should monitor its quality management procedures and policies at least annually.

D Every person within the audit firm has a responsibility to ensure quality management is adhered to.

9 Chapter summary

Planning

Purpose
- Enables an efficient & effective audit
- Resolve matters in a timely way
- Selection of team

Audit strategy
- Characteristics
- Significant factors & preliminary engagement activities
- Reporting objectives
- Resources

Audit plan
- Procedures to be performed
- Team member assigned
- Sample sizes
- Timing of the work

Interim audit
- Work performed before year end
- Reduces pressure on final audit
- Controls testing & substantive procedures

Laws & regulations
- Responsibilities
- Procedures to identify non-compliance
- Procedures to assess impact of non-compliance
- Reporting

Documentation
- Experienced auditor test
- Permanent file
- Current file
- Custody and retention

Quality management
- Ethical requirements
- Engagement resources
- Engagement performance
- Monitoring & remediation

Fraud
- Responsibilities
- Risk assessment
- Responding to fraud risk
- Reporting

Test your understanding answers

Test your understanding 1

(a) **Procedures to obtain an understanding of Rock Co**

- Review prior year working papers, and speak with the audit manager responsible for the prior year audit, to obtain an understanding of the client and to establish any matters that require attention in the current year.
- Enquire of Rock Co's management if there have been any significant changes to the business or issues arising during the year such as major customers or suppliers being lost or won.
- Enquire how management responds to the risk of fraud within the company and whether any frauds have been identified during the year.
- Enquire of management whether there has been any change in the financing of the company during the year e.g. new loans taken out or new shares issued.
- Review press reports/perform an internet search to identify any media coverage relating to the client.
- Review industry journals for information about the performance of the industry which can be used to compare with the client's performance and help identify unusual trends.
- Review management accounts, financial information provided to the stock exchange or draft financial statements that may be available to establish trends in the business.
- Perform analytical procedures to establish areas that indicate potential material misstatement and require attention during the audit.
- Review systems documentation (either generated by Rock Co or held by the firm) to identify changes in controls.
- Perform a walkthrough test to confirm understanding of how the internal controls operate.
- Review stock exchange requirements to identify any changes during the year.
- Review industry journals/correspondence with regulatory bodies to obtain an understanding of the legal and regulatory framework the company operates within.

(b) **Types and features of audit working papers**

Types of audit working papers include:

- Systems documentation (flowcharts, systems manuals, narrative notes, checklists and questionnaires, etc.)
- Constitutional documents
- Agreements with banks and other providers of finance
- Details of other advisors used by the entity such as lawyers
- Regulatory documentation relating to the stock exchange listing
- Audit planning documentation
- Audit work programs
- Working papers showing the work performed
- External confirmations from third parties such as the bank and customers confirming balances at the year end
- Lead schedules showing summaries of work performed and conclusions on individual account areas and the amounts to be included in the financial statements
- Trial balance, management accounts and financial statements
- Schedule of unadjusted differences
- Schedule of review points
- Report to management
- Written representation letter.

Features of audit working papers

- All working papers should show the name of the preparer and the date prepared, and the name of the reviewer and the date reviewed, by means of signatures and dates. These may be electronic in the case of electronic working papers.
- Audit planning documentation should include the risk assessment cross-referenced to the audit program, and the audit program should cross-reference to the audit working papers.
- Working papers showing the work performed should be cross-referenced to the audit program and the lead schedule on that particular section of the audit file, and should describe the nature of the work performed, the evidence obtained, and the conclusions reached.

- Each section of the audit file should have a lead schedule cross-referenced to the relevant working papers.
- The trial balance should be cross-referenced to the relevant sections of the audit file where the audit work is documented, and to the financial statements.
- The schedule of unadjusted differences should be cross-referenced to the sections of the file to which they relate.
- A schedule of review points should be 'cleared' to show that all outstanding matters have been dealt with.

Test your understanding 2

1	A	The auditor should plan and perform the audit to have a reasonable expectation of detecting material fraud and error. However, if a fraud is very well concealed, even a very thorough audit may not detect it.
2	D	Material misstatements are brought to the attention of the shareholders by modifying the audit opinion.
3	D	All three procedures must be performed to respond to the risk of fraud.
4	B	Options A and C describe aspects of the audit strategy The audit strategy is developed before the audit plan.
5	C	Specific procedures are included in the audit plan.

Test your understanding 3

1	C	Financial statements cannot be verified as being correct due to the inclusion of estimates and judgements.
2	D	'Final' analytical procedures are performed at the completion stage of the audit.
3	B	The interim audit helps to develop the audit strategy. It should take place before the year end to avoid interfering with the client's year-end procedures but should not be so early that it is of little use.
4	A	Written representations are obtained at the end of the audit, just before the auditor's report is signed.
5	C	An interim audit may result in increased fees for the firm if a greater amount of work is performed, however, this is not a reason for performing an interim audit. The interim audit is a means of spreading the workload over a longer period to avoid time pressure.

Test your understanding 4

1	C	Engagement quality review is part of engagement performance.
2	D	Quality is important for upholding the reputation of the profession and the firm in order to maintain investor confidence. Avoiding punishment is not the primary reason for ensuring a quality audit is performed.
3	A	Briefing of the audit teams forms part of the direction of the audit.
4	B	An EQR should be performed by someone independent of the engagement team and someone who is capable and competent. NO is the only partner who meets these requirements. JK has limited experience at partner level therefore is unlikely to have sufficient competence at this time to be the engagement quality reviewer. PQ and RS are both experienced but are already fully utilised and the reviewer must be able to devote sufficient time to the role, therefore would not be appropriate. YZ is experienced and has some spare capacity but is due to move to a part time role and is therefore unlikely to have sufficient time available to perform the quality review given the current utilisation rate of 95%.
5	B	The firm should perform its own quality reviews and take remedial action as necessary to ensure quality management procedures are followed.

Chapter

7

Evidence

Chapter learning objectives

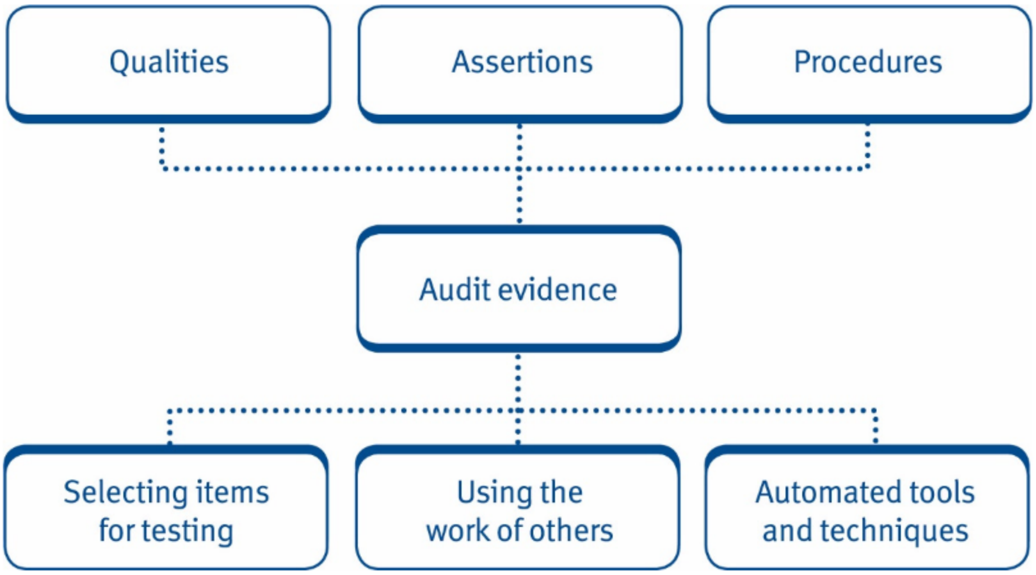
This chapter covers syllabus areas:

- C1a – The need to obtain an understanding of internal control relevant to the audit
- D1 – Assertions and audit evidence
- D2 – Audit procedures
- D3 – Audit sampling and other means of testing
- D5 – Automated tools and techniques
- D6 – The work of others

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO19) is to collect and evaluate evidence for an audit. Carry out an internal or external audit from collecting evidence, through to forming an opinion. You demonstrate professional scepticism and make sure judgements are based on sufficient valid evidence. Working through this chapter should help you understand how to demonstrate that objective.



1 Audit evidence

ISA 500 *Audit Evidence* states the objective of the auditor, in terms of gathering evidence, is:

'**to design and perform audit procedures in such a way to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion**.' [ISA 500, 4]

- **Sufficiency** relates to the **quantity** of evidence.
- **Appropriateness** relates to the **quality** or relevance and reliability of evidence.

[ISA 500, 5b, 5e]

Sufficient evidence

The auditor needs to gather 'enough' evidence to form a conclusion. This is a matter of professional judgement. When determining whether there is enough evidence the auditor must consider:

- The risk of material misstatement
- The materiality of the item
- The nature of accounting and internal control systems
- The results of controls tests
- The auditor's knowledge and experience of the business
- The size of a population being tested
- The size of the sample selected to test
- The reliability of the evidence obtained.

e.g

Sufficient evidence

Consider the audit of a bank balance:

The auditor will confirm year-end bank balances directly with the bank. This is a good source of evidence but on its own is not sufficient to give assurance regarding the completeness and final valuation of bank and cash amounts. The key reason is timing differences. The client may have received cash amounts or cheques before the end of the year, or may have paid out cheques before the end of the year, that have not yet cleared the bank account. For this reason, the auditor should also review and reperform the client's year-end bank reconciliation. In combination, these two pieces of evidence will be sufficient to give assurance over the bank balances.

Appropriate evidence

Appropriateness of evidence breaks down into two important concepts:

- Reliability
- Relevance.

Reliability

The auditor should always attempt to obtain evidence from the most trustworthy and dependable source possible.

- Evidence obtained from an independent external source is more reliable than client generated evidence.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.
- Client generated evidence is the least reliable source of evidence. If the client is manipulating the financial statement figures they may produce fictitious evidence to support the figures. Client generated evidence is more reliable if effective controls are in place. This doesn't mean the auditor should not rely on client generated evidence. It simply means that where more reliable evidence is available, the auditor should obtain it.
- In addition, written evidence is more reliable than oral evidence as oral representations can be withdrawn or challenged. Original documents are more reliable than copies or documents transformed into electronic form as it may be difficult to see if these have been tampered with.

[ISA 500, A31]

Broadly speaking, the more reliable the evidence the less of it the auditor will need. However, if evidence is unreliable it will never be appropriate for the audit, no matter how much is gathered. [ISA 500, A4]

Relevance

Relevance means the evidence relates to the financial statement assertions being tested. [ISA 500, A27]

For example, when attending an inventory count, the auditor will:

- Select a sample of items from physical inventory and trace them to inventory records to confirm the **completeness** of accounting records
- Select a sample of items from inventory records and trace them to physical inventories to confirm the **existence** of inventory assets.

Whilst the procedures are similar in nature, their purpose (and relevance) is to test different **assertions** regarding inventory balances.

2 Financial statements assertions

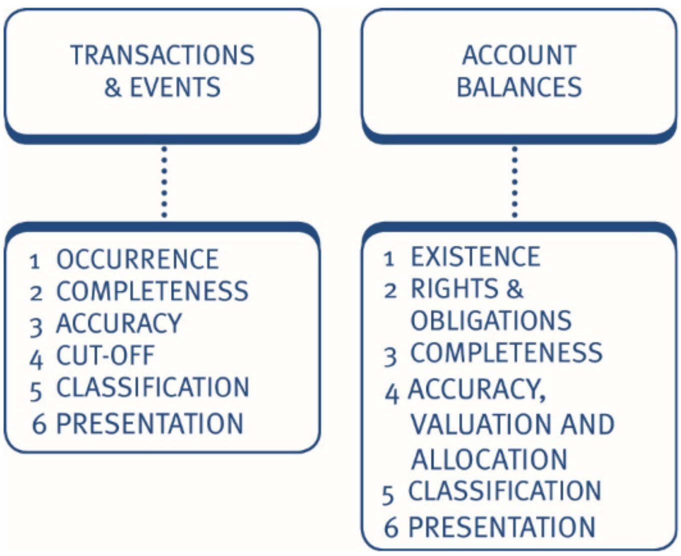
The objective of audit testing is to assist the auditor to reach a conclusion as to whether the financial statements are free from material misstatement.

The auditor will perform a range of tests on the significant classes of transactions and account balances. These tests focus on the **financial statement assertions**.

Assertions: 'Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework.

Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.'

[ISA 315 (Revised 2019), 12a]



Assertions about classes of transactions and events, and related disclosures, for the period under audit

Occurrence – the transactions and events recorded and disclosed have occurred and pertain to the entity.

Completeness – all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included have been included.

Accuracy – amounts and other data have been recorded appropriately and related disclosures have been appropriately measured and described.

Cut-off – transactions and events have been recorded in the correct accounting period.

Classification – transactions and events have been recorded in the proper accounts.

Presentation – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the applicable financial reporting framework.

[ISA 315 (Revised 2019), A190a]

Assertions about account balances and related disclosures at the period end

Existence – assets, liabilities and equity interests exist.

Rights and obligations – the entity holds or controls the rights to assets and liabilities are the obligations of the entity.

Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included have been included.

Accuracy, valuation and allocation – assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Classification – assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – account balances are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the applicable financial reporting framework.

[ISA 315 (Revised 2019), A190b]

Inventory misstatements

There are many ways inventory could be materially misstated:

- Items might not be counted and therefore not be included in the balance. This would mean the inventory balance was not **complete**.
- Items delivered after the year end could be included in this accounting period. This would mean the inventory did not **exist** at the year-end date.
- Damaged or obsolete inventory might not be **valued** appropriately at the lower of cost and net realisable value.
- Purchase costs might not be recorded accurately. This would also affect **valuation**.
- Inventory stored at the client's site may belong to a 3rd party. The client would not have the **right** to include this inventory in their financial statements.

Addressing disclosures in the audit of financial statements

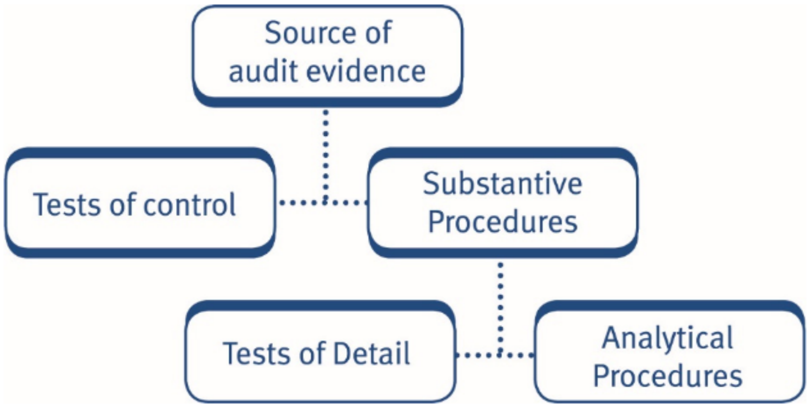
Disclosures are an important part of the financial statements and seen as a way for communicating further information to users. Poor quality disclosures may obscure understanding of important matters.

Concerns have been raised about whether auditors are giving sufficient attention to disclosures during the audit. The IAASB believes that where the term financial statements is used in the ISAs, it should be clarified that this is intended to include all disclosures subject to audit.

Recent changes to ISAs include:

- Emphasis on the importance of giving appropriate attention to addressing disclosures.
- Focus on matters relating to disclosures to be discussed with those charged with governance, particularly at the planning stage.
- Emphasis on the need to agree with management their responsibility to make available information relevant to disclosures, early in the audit process.

3 Sources of audit evidence



Auditors can obtain assurance from:

Tests of control: Audit procedures '**designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatement**'.

Substantive procedures: Audit procedures '**designed to detect material misstatements at the assertion level**'.

[ISA 330, 4]

Tests of controls

In order to design further audit procedures, the auditor must assess the risk of material misstatement in the financial statements.

Remember: Audit risk = Inherent risk × Control risk × Detection risk

Internal controls are a vital component of this risk model, they are the mechanisms that clients design in an attempt to prevent, detect and correct misstatement. This is not only necessary for good financial reporting, it is necessary to safeguard the assets of the shareholders and is a requirement of corporate governance.

The stronger the control system, the lower the control risk. This reduces the risk of material misstatement in the financial statements.

In order to be able to rely on controls the auditor will need to:

- Ascertain how the system operates
- Document the system in audit working papers
- Assess the design and operating effectiveness of the control system
- Test the operation of the system
- Determine the impact on the audit approach for specific classes of transactions, account balances and disclosures.

The focus of a test of control is not the monetary amount of a transaction. A test of control provides evidence of whether a control procedure has operated effectively. For example, inspecting an invoice for evidence of authorisation. It is irrelevant whether the invoice is for $100 or $1000 as it the control being tested, not the amount. Therefore, it could be said that a test of control provides indirect evidence over the financial statements. The auditor makes the assumption that if controls are working effectively there is less risk of material misstatement in the financial statements. However, the test of control itself does not test the figure within the financial statements, this is the purpose of a substantive procedure.

We will learn more about the systems themselves and tests of controls in the chapter 'Systems and controls'.

Substantive procedures

Substantive procedures consist of:

- **Tests of detail:** to verify individual transactions and balances.
- **Substantive analytical procedures:** involve analysing relationships between information to identify unusual fluctuations which may indicate possible misstatement.

Tests of detail v analytical procedures

A test of detail looks at the supporting evidence for an individual transaction such as inspection of a purchase invoice to verify the amount/date/classification of a specific purchase. If there are 5000 purchase invoices recorded during the accounting period, this one test of detail has only provided evidence for one of those transactions.

An analytical procedure would be used to assess the reasonableness of the purchases figure in total. For example, calculating the percentage change in purchases from last year and comparing this with the percentage change in revenue to see if they move in line with each other as expected.

The analytical procedure is not looking at the detail of any of the individual purchases but at the total figure. It is possible that there are a number of misstatements within the purchases population which would only be discovered by testing the detail as they may cancel each other out. An analytical procedure would not detect these misstatements.

Because of this, analytical procedures should only be used as the main source of substantive evidence where the internal controls have been found to be reliable, as there is less chance of misstatements being present as the control system would have detected and corrected them.

In some circumstances the auditor may rely solely on substantive testing:

- The auditor may choose to rely solely on substantive testing where it is considered to be a more efficient or more effective way of obtaining audit evidence, e.g. for smaller organisations.
- The auditor may have to rely solely on substantive testing where the client's internal control system cannot be relied on.

The auditor must always carry out substantive procedures on material items. [ISA 330 *The Auditor's Response to Assessed Risks*, 18].

The auditor is required to carry out the following substantive procedures:

- Agreeing the financial statements to the underlying accounting records.
- Examination of material journals and other adjustments made in preparing the financial statements.

[ISA 330, 20]

4 Types of audit procedure

The auditor can adopt the following procedures to obtain audit evidence:

- Inspection of records, documents or physical assets.
- Observation of processes and procedures, e.g. inventory counts.
- External confirmation obtained in the form of a direct written response to the auditor from a third party.
- Recalculation to confirm the numerical accuracy of documents or records.
- Reperformance by the auditor of procedures or controls.
- Analytical procedures.
- Enquiry of knowledgeable parties.

[ISA 500, A14 – A22]

In the chapter 'Procedures' we will look in detail at how these procedures are applied to specific items in the financial statements.

Explanation of audit procedures

Inspection of documents and records: examining records or documents, in paper or electronic form.

- May give evidence of rights and obligations, e.g. title deeds.
- May give evidence that a control is operating, e.g. invoices stamped as paid or authorised for payment by an appropriate signature.
- May give evidence about cut-off, e.g. the dates on invoices, despatch notes, etc.
- Confirms sales values and purchases costs.

Inspection of tangible assets: physical examination of an asset.

- To obtain evidence of existence of that asset.
- May give evidence of valuation, e.g. evidence of damage indicating impairment of inventory or non-current assets.

Observation: looking at a process or procedure being performed by others.

- May provide evidence that a control is being operated, e.g. segregation of duties or a physical check.
- Only provides evidence that the control was operating properly at the time of the observation. The auditor's presence may have had an influence on the operation of the control.
- Observation of a one-off event, e.g. an inventory count, may give good evidence that the procedure was carried out effectively.

Enquiry: seeking information from knowledgeable persons, both financial and non-financial, within the entity or outside.

Whilst a major source of evidence, the results of enquiries will usually need to be corroborated in some way through other audit procedures. This is because responses generated by the audit client are considered to be of a low quality due to their inherent bias.

The answers to enquiries may be corroborative evidence. In particular, they may be used to corroborate the results of analytical procedures.

Written representations from management are part of overall enquiries. These involve obtaining written statements from management to confirm oral enquiries. These are considered further in the chapter 'Completion and review'.

External confirmation: obtaining a direct response (usually written) from an external, third party.

- Examples include:
  - Circularisation of receivables
  - Circularisation of payables where supplier statements are not available
  - Confirmation of bank balances in a bank letter
  - Confirmation of actual/potential penalties from legal advisers
  - Confirmation of inventories held by third parties.
- May provide good evidence of existence of balances, e.g. receivables confirmation.
- May not provide reliable evidence of valuation, e.g. customers may confirm receivable amounts but, ultimately, be unable to pay in the future.

Recalculation: manually or electronically checking the arithmetical accuracy of documents, records, or the client's calculations, e.g. recalculation of the translation of a foreign currency transaction.

Reperformance: the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control system, e.g. reperformance of a bank reconciliation.

Analytical procedures: analysis of plausible relationships between data. See below.

Analytical procedures as substantive tests

We have already seen analytical procedures used as a risk assessment procedure at the planning stage (preliminary analytical procedures). Later in the text we will see them performed at the completion stage of the audit. Here we consider their use as substantive procedures, i.e. procedures designed to detect material misstatement.

Analytical procedures are used to identify trends and understand relationships between sets of data. This in itself will not detect misstatement but will identify possible areas of misstatement. As such, analytical procedures cannot be used in isolation and should be coupled with other, corroborative, forms of testing, such as enquiry of management.

When performing analytical procedures, the auditor does not simply look at current figures in comparison to last year, they may consider other points of comparison, such as budgets and industry data.

Other techniques are also available, including:

- Ratio analysis
- Trend analysis
- Proof in total, for example: an auditor can create an expectation of payroll costs for the year by taking last year's cost and inflating for pay rises and changes in staff numbers.

Analytical procedures are useful for assessing several assertions at once as the auditor is effectively auditing a whole account balance or class of transaction to see if it is reasonable.

They can be used to corroborate other audit evidence obtained, such as statements by management about changes in cost structures.

By using analytical procedures, the auditor may identify unusual items that can then be further investigated to ensure that a misstatement doesn't exist in the balance.

However, in order to use analytical procedures effectively, the auditor needs to be able to create an expectation. It would be difficult to do this if operations changed significantly from the prior year. If the changes were planned, the auditor could use forecasts as a point of comparison, although these are inherently unreliable due to the number of estimates involved. In this situation it would be pointless comparing with past results as the business would be too different to be able to conduct effective comparison.

It would also be difficult to use analytical procedures if a business had experienced a number of significant one-off events in the year as these would distort the figures making comparison to both prior year and budget meaningless.

The suitability of analytical procedures as substantive tests

To use analytical procedures, the auditor must:

1. Develop an expectation
2. Define the difference or threshold of variation which is considered acceptable
3. Calculate the difference between the recorded amount and expected amount
4. Investigate the differences which are greater than the acceptable level of variation established in step 2.

The suitability of this approach depends on four factors:

- The assertion(s) under scrutiny
- The reliability of the data
- Whether the expectation developed by the auditor is sufficiently precise to identify a misstatement that may be material either individually or in aggregate
- Whether the difference between the recorded amount and expected amount is acceptable.

Assertions under scrutiny

Analytical procedures should be suitable for the assertion being tested. They are clearly unsuitable for testing the existence of inventories. They are, however, suitable for assessing the value of inventory in terms of the need for allowances against old inventories, identified using the inventory holding period ratio.

Analytical procedures are more suitable for testing balances which are likely to be predictable over time meaning relationships between data can be analysed to identify usual fluctuations e.g. the relationship between payroll cost and the number of employees.

Reliability of data

The source of the information will affect reliability as discussed earlier in the chapter. Reliability of comparable information is also an important factor. If controls over financial data are weak, the data is likely to contain misstatement and is therefore not suitable as a basis for assessment.

Expectation developed by the auditor

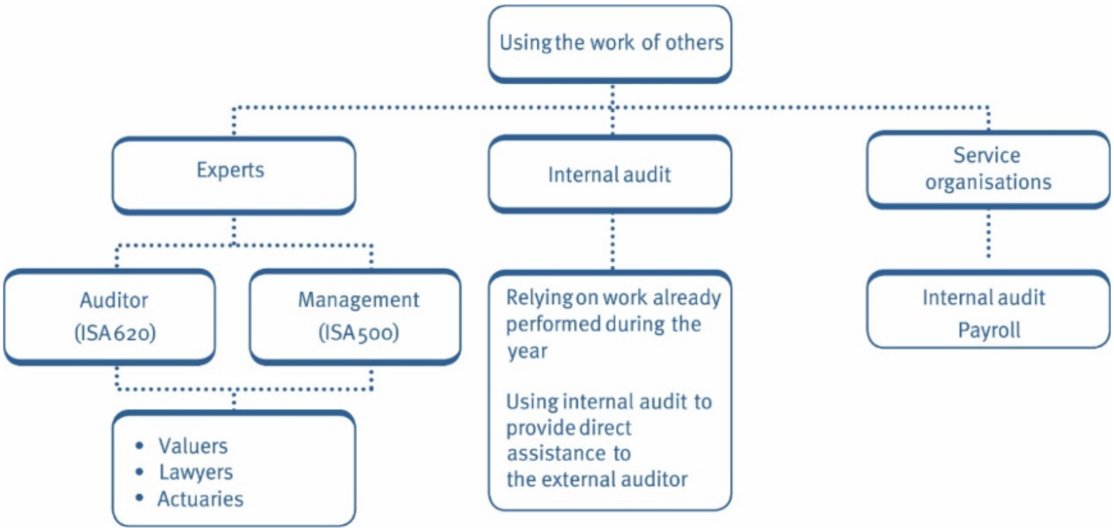
The auditor’s ability to develop an expectation will depend on the availability of reliable information.

The auditor will be able to develop a more precise expectation if disaggregated information is obtained and analysed. For example, when performing analytical procedures over revenue, it may be more meaningful if sales by month/customer/product/region are analysed rather than the revenue figure as a whole.

The difference between recorded amount and expected amount

The amount of acceptable variation between the expected figure and the actual figure will impact whether analytical procedures provide sufficient appropriate evidence. If the level of variation from actual is higher than the level of variation the auditor is willing to accept, further procedures will be necessary to ensure the balance in the financial statements is not materially misstated.

5 Relying on the work of others



There are two types of expert an auditor may use:

1 Management's expert – an employee of the client or someone engaged by the audit client who has expertise that is used to assist in the preparation of the financial statements.

2 Auditor's expert – an employee of the audit firm or someone engaged by the audit firm to provide sufficient appropriate evidence.

Relying on the work of a management's expert

ISA 500 *Audit Evidence* provides guidance on what the auditor should consider before relying on the work of a management's expert.

The auditor must:

- Evaluate the competence, capabilities and objectivity of that expert.
- Obtain an understanding of the work of that expert.
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

[ISA 500, 8]

e.g

Relying on the work of a management's expert

The auditor should ensure the expert management has chosen to use is competent to perform the work requested by the client. If the expert does not have relevant qualifications or experience, the work may not be reliable.

The auditor should assess whether the expert management has chosen is objective. If the expert is a close relative of a director at the client company, the expert may produce a report containing information provided by the client rather than being the result of work they have performed.

Relying on the work of an auditor's expert

ISA 620 *Using the Work of an Auditor's Expert* provides guidance to auditors.

If the auditor lacks the required technical knowledge to gather sufficient appropriate evidence to form an opinion, they may have to rely on the work of an expert.

Examples of such circumstances include:

- The valuation of complex financial instruments, land and buildings, works of art, jewellery and intangible assets.
- Actuarial calculations associated with insurance contracts or employee benefit plans.
- The estimation of oil and gas reserves.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues.

[ISA 620, A1]

The auditor must determine if the expert's work is adequate for the auditor's purposes. [ISA 620, 5b]

To fulfil this responsibility, the auditor must **evaluate whether the expert has the necessary competence, capability and objectivity for the purpose of the audit**. [ISA 620, 9]

Evaluating competence [ISA 620, A15]

Information regarding the competence, capability and objectivity on an expert may come from a variety of sources, including:

- Personal experience of working with the expert.
- Discussions with the expert.
- Discussions with other auditors.
- Knowledge of the expert's qualifications, memberships of professional bodies and licences.
- Published papers or books written by the expert.
- The audit firm's system of quality management.

Evaluating objectivity [ISA 620, A20]

Assessing the objectivity of the expert is particularly difficult, as they may not be bound by a similar code of ethics as the auditor and, as such, may be unaware of the ethical requirements and threats with which auditors are familiar.

It may therefore be relevant to:

- Make enquiries of the client about known interests or relationships with the chosen expert.
- Discuss applicable safeguards with the expert.
- Discuss financial, business and personal interests in the client with the expert.
- Obtain written representation from the expert.

Agreeing the work [ISA 620, 11]

Once the auditor has considered the above matters they must then obtain written agreement from the expert of the following:

- The nature, scope and objectives of the expert’s work.
- The roles and responsibilities of the auditor and the expert.
- The nature, timing and extent of communication between the two parties.
- The need for the expert to observe confidentiality.

Evaluating the work [ISA 620, 12]

Once the expert's work is complete the auditor must scrutinise it and evaluate whether it is appropriate for audit purposes.

In particular, the auditor should consider:

- The reasonableness of the findings and consistency with other evidence.
- The significant assumptions made.
- The use and accuracy of source data.

Reference to the work of an expert

The auditor cannot devolve responsibility for forming an audit opinion, they must use their professional judgement to assess whether the evidence produced by the expert is sufficient and appropriate to support the audit opinion.

The use of an auditor’s expert is not mentioned in an unmodified auditor's opinion unless required by law or regulation. Reference to the work of an expert may be included in a modified opinion if it is relevant to the understanding of the modification. This does not diminish the auditor’s responsibility for the opinion. [ISA 620, 14 & 15]

Relying on internal audit

ISA 610 *Using the Work of Internal Auditors* provides guidance.

An internal audit department forms part of the client's system of internal control. If this is an effective element of the control system it may reduce control risk, and therefore reduce the need for the auditor to perform detailed substantive testing.

Additionally, external auditors may be able to co-operate with a client's internal audit department and place reliance on their procedures in place of performing their own.

Before relying on the work of internal audit, the external auditor must assess the effectiveness of the internal audit function and assess whether the work produced by the internal auditor is adequate for the purpose of the audit.

Evaluating the internal audit function [ISA 610, 15]

- The extent to which the internal audit function's **organisational status** and relevant policies and procedures support the **objectivity** of the internal auditors.
- The **competence** of the internal audit function.
- Whether the internal audit function applies a systematic and disciplined **approach**.

Evaluating objectivity [ISA 610, A7]

- Whether the internal audit function reports to those charged with governance or has direct access to those charged with governance.
- Whether the internal audit function is free from operational responsibility.
- Whether those charged with governance are responsible for employment decisions such as remuneration.
- Whether any constraints are placed on the internal function by management or those charged with governance.
- Whether the internal auditors are members of a professional body which requires compliance with ethical requirements.

Evaluating competence [ISA 610, A8]

- Whether the resources of the internal audit function are appropriate and adequate for the size of the organisation and nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether internal auditors have adequate technical training and proficiency, including relevant professional qualifications and experience.

- Whether the internal auditors have the required knowledge of the entity's financial reporting and the applicable financial reporting framework and possess the necessary skills to perform work related to the financial statements.
- Whether the internal auditors are members of a professional body which requires continued professional development.

Evaluating the systematic and disciplined approach [ISA 610, A11]

- Existence, adequacy and use of internal audit procedures and guidance.
- Application of quality control policies and procedures.

If the external auditor considers it appropriate to use the work of the internal auditors they then have to determine the areas and extent to which the work of the internal audit function can be used (by considering the nature and scope of work) and incorporate this into their planning to assess the impact on the nature, timing and extent of further audit procedures. [ISA 610, 17]

Evaluating the internal audit work [ISA 610, 23]

- The work was properly planned, performed, supervised, reviewed and documented.
- Sufficient appropriate evidence has been obtained.
- The conclusions reached are appropriate in the circumstances.
- The reports prepared are consistent with the work performed.

To evaluate the work adequately, the external auditor must reperform some of the procedures that the internal auditor has performed to ensure they reach the same conclusion. [ISA 610, 24]

The extent of the work to be performed on the internal auditor's work will depend on the amount of judgement involved and the risk of material misstatement in that area. [ISA 610, 24]

When reviewing and reperforming some of the work of the internal auditor, the external auditor must consider whether their initial expectation of using the work of the internal auditor is still valid. [ISA 610, 25]

Note that the auditor is not required to rely on the work of internal audit. In some jurisdictions, the external auditor may be prohibited or restricted from using the work of the internal auditor by law.

Responsibility for the auditor's opinion cannot be devolved and no reference should be made in the auditor's report regarding the use of others during the audit.

Using the internal audit to provide direct assistance

External auditors can consider whether the internal auditor can provide direct assistance with gathering audit evidence under the supervision and review of the external auditor. ISA 610 provides guidance to aim to reduce the risk that the external auditor over uses the internal auditor.

The following considerations will be made:

- Direct assistance cannot be provided where laws and regulations prohibit such assistance, e.g. in the UK. [ISA 610, 26]
- The competence and objectivity of the internal auditor. Where threats to objectivity are present, the significance of them and whether they can be managed to an acceptable level must be considered. [ISA 610, 27]
- The external auditor must not assign work to the internal auditor which involves significant judgement, a high risk of material misstatement or with which the internal auditor has been involved. [ISA 610, 30]
- The planned work must be communicated with those charged with governance so agreement can be made that the use of the internal auditor is not excessive. [ISA 610, 31]

Where it is agreed that the internal auditor can provide direct assistance:

- Management must agree in writing that the internal auditor can provide such assistance and that they will not intervene in that work. [ISA 610, 33a]
- The internal auditors must provide written confirmation that they will keep the external auditors information confidential. [ISA 610, 33b]
- The external auditor will provide direction, supervision and review of the internal auditor's work. [ISA 610, 34]
- During the direction, supervision and review of the work, the external auditor should remain alert to the risk that the internal auditor is not objective or competent. [ISA 610, 35]

Documentation [ISA 610, 37]

The auditor should document:

- The evaluation of the internal auditor's objectivity and competence.
- The basis for the decision regarding the nature and extent of the work performed by the internal auditor.
- The name of the reviewer and the extent of the review of the internal auditor's work.
- The written agreement of management mentioned above.
- The working papers produced by the internal auditor.

Use of service organisations

Many companies use service organisations to perform business functions such as:

- Payroll processing
- Receivables collection
- Pension management.

If a company uses a service organisation, audit evidence will need to be obtained from the service organisation instead of, or in addition to, the client. This needs to be considered when planning the audit.

ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* provides guidance to auditors.

Planning the audit

The auditor will need to:

- Obtain an understanding of the service organisation sufficient to identify and assess the risks of material misstatement.
- Design and perform audit procedures responsive to those risks.

[ISA 402, 1]

This requires the auditor to obtain an understanding of the service provided:

- Nature of the services and their effect on internal controls.
- Nature and materiality of the transactions to the entity.
- Level of interaction between the activities of the service organisation and the entity.
- Nature of the relationship between the service organisation and the entity, including contractual terms.

[ISA 402, 9]

The auditor should determine the effect the use of a service organisation will have on their assessment of risk. The following issues should be considered:

- Reputation of the service organisation.
- Existence of external supervision.
- Extent of controls operated by service provider.
- Experience of errors and omissions.
- Degree of monitoring by the user.

Sources of information about the service organisation

- Obtaining a type 1 or type 2 report from the service organisation's auditor.

  A Type 1 report provides a description of the design of the controls at the service organisation prepared by the management of the service organisation. It includes a report by the service auditor providing an opinion on the description of the system and the suitability of the controls. [ISA 402, 8b]

  A Type 2 report is a report on the description, design and operating effectiveness of controls at the service organisation. It contains a report prepared by management of the service organisation. It includes a report by the service auditor providing an opinion on the description of the system, the suitability of the controls, the effectiveness of the controls and a description of the tests of controls performed by the auditor. [para 8c]

  If the auditor intends to use a report from a service auditor, they should consider:

  – The competence and independence of the service organisation auditor.

  – The standards under which the report was issued.

- Contacting the service organisation through the client.
- Visiting the service organisation.
- Using another auditor to perform procedures that will provide the necessary information about controls at the service organisation.

[ISA 402, 12]

Responding to assessed risks

The auditor should determine whether sufficient appropriate evidence is available from the client and if not, perform further procedures or use another auditor to perform procedures on their behalf. [ISA 402, 15]

If controls are expected to operate effectively:

- Obtain a type 2 report if available and consider:

  – Whether the date covered by the report is appropriate for the audit.

  – Whether the client has any complementary controls in place.

  – The time elapsed since the tests of controls were performed.

  – Whether the tests of controls performed by the auditor are relevant to the financial statement assertions.

  [ISA 402, 17]

- Perform tests of controls at the service organisation.
- Use another auditor to perform tests of controls.

[ISA 402, 16]

The auditor should enquire of the client whether the service organisation has reported any frauds to them or whether they are aware of any frauds. [ISA 402, 19]

Impact on the auditor's report

If sufficient appropriate evidence has not been obtained, a qualified or disclaimer of opinion will be issued. [ISA 402, 20]

The use of a service organisation auditor is not mentioned in the auditor's report unless required by law or regulation. Reference to the work of a service organisation auditor may be included in a report containing a modified opinion if it is relevant to the understanding of the modification. This does not diminish the auditor’s responsibility for the opinion. [ISA 402, 21]

Benefits to the audit

- Independence: because the service organisation is external to the client, the audit evidence derived from it is regarded as being more reliable than evidence generated internally by the client.
- Competence: because the service organisation is a specialist, it may be more competent in executing its role than the client’s internal department resulting in fewer errors.
- Possible reliance on the service organisation’s auditors: it may be possible for the audit firm to confirm information directly with the service organisation’s auditors.

Drawbacks

The main disadvantage of outsourced services from the auditor's point of view concerns access to records and information.

The auditor has a legal right to access the client’s records and to receive answers and explanations that they consider necessary for the audit. They do not have such rights over records and information held by a third party such as a service organisation.

If access to records and other information is denied by the service organisation, this may impose a limitation on the scope of the auditor’s work. If sufficient appropriate evidence is not obtained, this will result in a modified audit opinion.

6 Selecting items for testing

The auditor has three options for selecting items to test:

1 Select all items to test (100% testing) [ISA 500, A54]

This approach may be taken where the population is very small and it is easy for the auditor to test all items. Alternatively, if it is an area over which the auditor requires greater audit confidence, for example an area that is material by nature or is considered to be of significant risk, the auditor may decide to test all items within the population.

2 Selecting specific items for testing [ISA 500, A55]

Items with specific characteristics may be chosen for testing such as:

- High value items within a population
- All items over a certain amount
- Items to obtain information.

Although less than 100% of the population is being tested, this does not constitute sampling. As explained below, sampling requires all items in the population to have a chance of selection. In the categories above, only the items with the specific characteristics have a chance of selection.

3 Sampling [ISA 500, A57]

The definition of sampling, as described in ISA 530 *Audit Sampling* is:

'**The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population**.' [ISA 530, 5a]

The need for sampling

It will usually be impossible to test every item in an accounting population because of the costs involved.

It is also important to remember that auditors give reasonable not absolute assurance and therefore do not certify that the financial statements are 100% accurate.

Selecting an appropriate sample

When sampling, the auditor must choose a representative sample.

- If a sample is representative, the same conclusion will be drawn from that sample as would have been drawn had the whole population been tested.
- For a sample to be representative, it must have the same characteristics as the other items in the population from which it was chosen. [ISA 530, A12]
- In order to reduce sampling risk and ensure the sample is representative, the auditor can increase the size of the sample selected or use stratification.

Stratification [ISA 530, Appendix 1]

Stratification is used in conjunction with sampling. Stratification is the process of breaking down a population into smaller subpopulations. Each subpopulation is a group of items (sampling units) which have similar characteristics.

The objective of stratification is to enable the auditor to reduce the variability of items within the subpopulation and therefore allow sample sizes to be reduced without increasing sampling risk.

For example, the auditor may stratify the population of revenue into three subpopulations: revenue from Product A, revenue from Product B and revenue from Product C. The auditor may select a sample of revenue from Product A. The results of the testing of that sample can be extrapolated across the whole subpopulation of revenue from Product A. A sample may be selected of revenue from Product B and again, the results of that testing can be extrapolated across that subpopulation. Revenue from Product C may not be tested if it is considered immaterial.

Statistical and non-statistical sampling

Statistical sampling means any approach to sampling that uses:

- Random selection of samples, and
- Probability theory to evaluate sample results.

Any approach that does not have both of these characteristics is considered to be non-statistical sampling. [ISA 530, 5g]

The approach taken is a matter of auditor judgement. [ISA 530, A9]

Statistical sampling methods [ISA 530, Appendix 4]

- **Random selection** – this can be achieved through the use of a random number generator or table.
- **Systematic selection** – where a constant sampling interval is used (e.g. every 50th balance) and the first item is selected randomly.
- **Monetary unit selection** – selecting items based upon monetary values (usually focusing on higher value items).

Non-statistical sampling methods

- **Haphazard selection** – the auditor does not follow a structured technique but avoids bias or predictability.
- **Block selection** – this involves selecting a block of contiguous items from the population (i.e. next to each other). To reduce sampling risk, many blocks should be selected as valid references cannot be made beyond the period or block examined.

When non-statistical methods (haphazard and block) are used, the auditor uses judgement to select the items to be tested. Whilst this lends itself to auditor bias it does support the risk-based approach, where the auditor focuses on those areas most susceptible to material misstatement.

Designing a sample [ISA 530, A5, A6]

When designing a sample, the auditor has to consider:

- The purpose of the procedure
- The combination of procedures being performed
- The nature of evidence sought
- Possible misstatement conditions.

e.g

Illustration 1 – Murray Co sampling

Sampling

Murray Co deals with large retail customers, and therefore has a small number of large receivables balances on the list of individual customers. Given the small number of customers with an outstanding balance, all balances would probably be selected for testing. However, for illustrative purposes the following shows how a sample of balances would be selected using systematic and Monetary Unit Sampling.

The number of items to be sampled has been determined as six. The customer list has been alphabetised.

Systematic Sampling

There are 19 customers with balances. The sampling interval is calculated by taking the total number of balances and dividing it by the sample size. The sampling interval (to the nearest whole number) is therefore three. The first item is chosen randomly, in this case item 10. Every third item after that is then also selected for testing until six items have been chosen.

Customer Ref	Customer Name	Balance $000	Item number	Sampling Item
A001	Anfield United Shop	176	1	
B002	The Beautiful Game	84	2	
B003	Beckham's	42	3	(5)
C001	Cheryl & Coleen Co	12	4	
D001	Dream Team	45	5	
E001	Escot Supermarket	235	6	(6)
G001	Golf is Us	211	7	
G002	Green Green Grass	61	8	
H001	HHA Sports	59	9	
J001	Jilberts	21	10	(1)
J002	James Smit Partnership	256	11	
J003	Jockeys	419	12	
O001	The Oval	92	13	(2)
P001	Pole Vaulters	76	14	
S001	Stayrose Supermarket	97	15	
T001	Trainers and More	93	16	(3)
W001	Wanderers	89	17	
W003	Walk Hike Run	4	18	
W004	Winners	31	19	(4)

Monetary Unit Sampling

Monetary Unit Sampling can utilise either the random or systematic selection method. This example illustrates the systematic selection method.

The cumulative balance is calculated.

The sampling interval is calculated by taking the total value of $2,103,000 (to the nearest $000) and dividing by the sample size of 6. The sampling interval is therefore $351,000.

The first item is chosen randomly (a number between 1 and 2,103,000), in this case 233. Each item after that is selected by adding the sampling interval to the last value until six items have been selected.

Customer Ref	**Customer Name**	**Balance** $000	**Cumulative**	**Sampling Item**
A001	Anfield United Shop	176	176	
B002	The Beautiful Game	84	260	(1) $233
B003	Beckham's	42	302	
C001	Cheryl & Coleen Co	12	314	
D001	Dream Team	45	359	
E001	Escot Supermarket	235	594	(2) $584
G001	Golf is Us	211	805	
G002	Green Grass	61	866	
H001	HHA Sports	59	925	
J001	Jilberts	21	946	(3) $935
J002	James Smit Partnership	256	1,202	
J003	Jockeys	419	1,621	(4) $1,286
O001	The Oval	92	1,713	(5) $1,637
P001	Pole Vaulters	76	1,789	
S001	Stayrose Supermarket	97	1,886	
T001	Trainers and More	93	1,979	
W001	Wanderers	89	2,068	(6) $1,988
W003	Walk Hike Run	4	2,072	
W004	Winners	31	2,103	

Evaluating deviations and misstatements in a sample

Deviations

Any issues identified during tests of control are called **deviations**.

The auditor will:

- Determine a level of deviation they are willing to accept – tolerable deviation rate.
- Test the sample stated in the audit plan.
- Extend the sample if deviations are identified.
- Compare the actual deviation rate to the tolerable deviation rate.
- Increase the level of substantive testing over the balance if the actual deviation rate exceeds the tolerable deviation rate.
- Communicate the control deficiency causing the deviation with management and those charged with governance.
  Communication of control deficiencies is covered in more detail in the chapter 'Systems and controls'.

e.g

Evaluating deviations in a sample

The auditor tests a sample of 100 purchase orders for evidence of authorisation and identifies 10 have not been authorised. This gives an initial deviation rate of 10%.

The auditor will extend the testing to obtain more evidence about the deviation rate. A further 20 invoices are tested and no further deviations are identified, the deviation rate is now 8.3% (10/120 × 100).

The tolerable deviation rate has been set at 5%. Therefore, the actual deviation rate is higher than the deviation rate the auditor is willing to accept. Increased substantive testing will be required over purchases as reliance cannot be placed on the controls.

Misstatements

Misstatements are differences between the amounts actually recorded and what should have been recorded in the accounting records. Misstatements are identified when performing substantive tests of detail.

The auditor will:

- Determine a level of misstatement they are willing to accept – tolerable misstatement.
- Test the sample stated in the audit plan.

- Consider the nature and cause of the misstatement. If the misstatement is an anomaly (isolated), no further procedures are required as the misstatement is not representative of further misstatements.
- Project the misstatement found in the sample across the population as a whole, if the misstatement is not isolated.
- Compare the total projected misstatement to tolerable misstatement.
  - If the total projected misstatement in the sample is less than tolerable misstatement, the auditor may be reasonably confident that the risk of material misstatement in the whole population is low and no further testing will be required.
  - If the total projected misstatement in the sample exceeds tolerable misstatement, the auditor will extend the sample in order to determine the total misstatement in the population.
- Communicate the misstatement with management and ask them to correct it. Communication of misstatements is covered in more detail in the chapter 'Completion and review'.

e.g

Evaluating misstatements in a sample

A sample of $50,000 has been tested out of a population of $800,000. Misstatements of $2,000 were found. Tolerable misstatement has been set at $10,000.

The auditor needs to consider whether the misstatement is an anomaly and therefore isolated, or whether the misstatement is likely to be representative of further misstatements in the population.

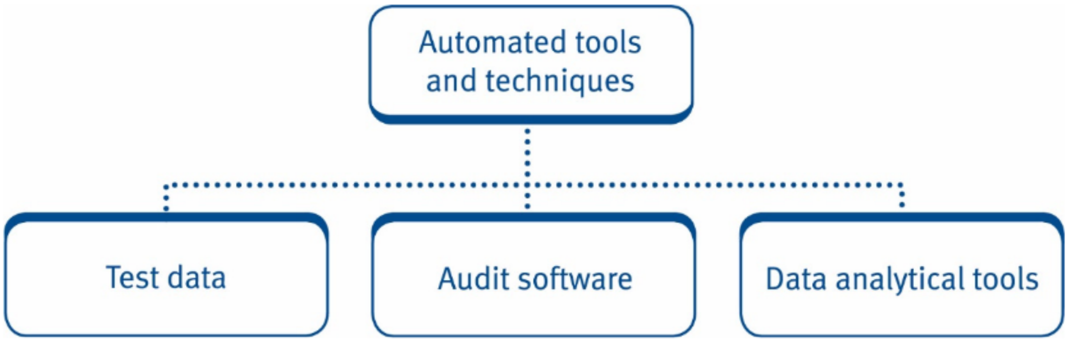
If the misstatement is an anomaly, no further procedures will be necessary.

If the misstatement is representative of further misstatements, the auditor will extrapolate the effect of the misstatement across the population to assess whether the projected misstatement is greater than tolerable misstatement.

Here, the auditor might expect that there are misstatements of $32,000 ($2,000/$50,000 × $800,000) in the population.

As the projected misstatement of $32,000 exceeds tolerable misstatement of $10,000, further audit testing will be required.

7 Automated tools and techniques



Test data

Test data involves the auditor submitting 'dummy' data into the client's system to ensure that the system correctly processes it and that it prevents or detects and corrects misstatements. The objective of this is to test the operation of information processing controls within the system.

To be successful test data should include both data with errors built into it and data without errors. Examples of errors include:

- Codes that do not exist, e.g. customer, supplier and employee.
- Transactions above predetermined limits, e.g. salaries above contracted amounts, credit above limits agreed with customer.
- Invoices with arithmetical errors.
- Submitting data with incorrect batch control totals.

Data may be processed during a normal operational cycle ('live' test data) or during a special run at a point in time outside the normal operational cycle ('dead' test data). Both have advantages and disadvantages, for example:

- Live tests could interfere with the operation of the system or corrupt master files/standing data.
- Dead testing avoids this issue but only gives assurance that the system works when not operating live. This may not be reflective of the strains the system is put under in normal conditions.

Advantages of test data

- Enables the auditor to test programmed controls which wouldn't otherwise be able to be tested.
- Once designed, costs incurred will be minimal unless the programmed controls are changed requiring the test data to be redesigned.

Disadvantages of test data

- Risk of corrupting the client's systems.
- Requires time to be spent on the client's system if used in a live environment which may not be convenient for the client.

Audit software

Audit software is used to interrogate a client's system. It can be either packaged, off-the-shelf software or it can be purpose written to work on a client's system. The main advantage of these programs is that they can be used to scrutinise large volumes of data, which would be inefficient to do manually. The programs can then present the results so that they can be investigated further.

Specific procedures that can be performed include:

- Extracting samples according to specified criteria, such as:
  - random
  - over a certain amount e.g. individually material balances or expenses
  - below a certain amount e.g. debit balances on the list of supplier balances or credit balances on the list of customer balances
  - at certain dates e.g. receivables or inventory over a certain age
- Calculating ratios and indicators that fail to meet certain predefined criteria (i.e. benchmarking)
- Casting ledgers and schedules
- Recalculation of amounts such as depreciation
- Preparing reports (budget vs actual)
- Stratification of data (such as invoices by customer or age)
- Identifying changes to standing data e.g. employee or supplier bank details
- Producing letters to send out to customers and suppliers.

These procedures can simplify the auditor's work by selecting samples for testing, identifying risk areas and by performing certain substantive procedures. The software does not, however, replace the need for the auditor's own procedures.

Advantages of audit software

- Calculations and casting of reports will be quicker.
- More transactions can be tested as compared with manual testing.
- The computer files are tested rather than printouts.
- Can be cost effective once set up.

Disadvantages of audit software

- Bespoke software (specific to a client) can be expensive to set up.
- Training of audit staff will be required incurring additional cost.
- The audit software may slow down or corrupt the client's systems.
- If errors are made in the design of the software, issues may go undetected by the auditor.

Automated tools

General advantages

- Enables the auditor to test more items more quickly.
- The auditor is able to test the system rather than printouts.
- The results can be compared with other tests to increase audit confidence.
- Audit tests can be performed more cost effectively.

Disadvantages

- Can be expensive and time consuming to set up.
- Client permission and cooperation may be difficult to obtain.
- Potential incompatibility with the client's computer system.
- The audit team may not have sufficient IT skills and knowledge to create the complex data extracts and programming required.
- The audit team may not have the knowledge or training needed to understand the results.
- Data may be corrupted or lost during the process.

Other types of automated tools

Integrated test facilities – this involves the creation of dummy ledgers and records to which test data can be sent. This enables more frequent and efficient test data procedures to be performed live and the information can simply be ignored by the client when printing out their internal records.

Embedded audit software – this requires a purpose written audit program to be embedded into the client's accounting system. The program will be designed to perform certain tasks (similar to audit software) with the advantage that it can be turned on and off at the auditor's wish throughout the accounting year. This allows the auditor to gather information on certain transactions (perhaps material ones) for later testing, and can identify peculiarities that require attention.

Data analytical tools

Data analytics (DA) is the science and art of discovering and analysing patterns, deviations and inconsistencies, and extracting other useful information in the data of underlying or related subject matter of an audit through analysis, modelling, visualisation for the purpose of planning and performing the audit.

Big data refers to data sets that are large or complex.

Big data technology allows the auditor to perform procedures on very large or complete sets of data rather than samples.

Features of data analytics

- DA can be used throughout the audit to help identify risks, test the controls, and as part of substantive procedures. The results still need to be evaluated using the professional skills and judgement of the auditor in order to analyse the results and draw conclusions.
- DA can incorporate a wider range of data. For example, data can be extracted and analysed from social media, public sector data, industry data and economic data.

Benefits of data analytics

- The quality of the audit can be enhanced by the use of DA. DA enables the auditor to obtain a greater understanding of the entity and its environment. Professional scepticism and professional judgement are improved when the auditor has a better understanding. In addition, DA allows the auditor to manipulate 100% of the data in a population quickly, reducing sampling risk.
- Results can be visualised graphically which may increase the user-friendliness of the reports.
- Audit procedures can be performed more quickly and to a higher standard. This provides more time to analyse and interpret the results rather than gathering the information for analysis.
- Audit procedures can be carried out on a continuous basis rather than focused on the year end.
- Reporting to the client and users will be more timely as the work may be completed within weeks rather than months after the year end.
- The use of DA may result in more frequent interaction between the auditor and client over the course of the year.
- A reduction in billable hours as audit efficiency increases. Although this is good news for the client, it will mean lower fees for the auditor.

Limitations of data analytics

There are still limitations to the audit and therefore auditors need to be careful not to place too much confidence into the use of DA which could have a negative impact on audit quality.

- As with analytical procedures in general, the quality of DA depends on the reliability of the underlying data used. The data may not be complete, well-controlled or from a reliable source.
- Financial statements still contain a significant number of estimates.
- DA will not replace the need for auditors to use professional scepticism and professional judgement.

Because of these limitations, the auditor is still only able to give reasonable assurance even though 100% of a population may be tested.

e.g

Automated tools and techniques during the audit

Risk assessment

- DA may be used to analyse the number of journals posted manually and automatically by the system; the number of people processing journals and the time of day the journals are posted. This can help with the auditor's assessment of risk due to fraud if:
  - The number of manual versus automatic journals increases significantly.
  - The number of people processing journals increases.
  - Journals are posted outside of normal working hours.
- DA may be used to perform ratio analysis at the risk assessment stage to help identify risks of material misstatement.
- The information system of a client can be accessed directly or by download to enable the auditor to obtain an understanding of how transactions flow through the system.

Substantive procedures

- Drones may be used to perform inspections of inventory where the auditor is unable to attend or physical access is restricted.
- DA can be used to perform substantive analytical procedures such as ratio analysis or trend analysis in respect of sales and purchases.
- DA may be used to identify if ledgers with zero balances are due to a number of offsetting transactions indicating that the ledger balance may be significant.

The Growing Use of Data Analytics in an Audit

What it means for the profession

- Larger accountancy firms are developing their own data analytic platforms. This requires significant investment in computer hardware and software, training of staff and quality control.
- Small firms are unlikely to have the resources available to develop their own software as the cost is likely to be too prohibitive. However, external computer software companies have developed audit systems that work with popular accounting systems such as Sage, Xero and Intuit which many clients of small accountancy firms may be using.
- Medium sized firms may also find the level of investment too restrictive and may therefore be unable to compete with the larger audit firms for listed company audits. However, these firms may find that listed companies require systems and controls assurance work which their auditors would not be allowed to perform under ethical standards.

Developments within the profession

Currently, ISAs take a systems-based approach to audit, which seeks to obtain audit evidence by placing reliance on internal controls rather than on carrying out extensive substantive tests of detail. The development of DA represents a significant progression away from traditional auditing methods. Therefore, as they become more widely used, ISAs will need to be updated to reflect this innovation in auditing techniques.

The IAASB has a responsibility to develop standards that reflect the current environment and facilitate a high-quality audit. Auditors, audit oversight authorities and standard setters need to work together to explore how developments in technology can support enhanced audit quality.

Auditors and businesses operate in an environment with larger volumes of transactions, greater complexity and greater regulation as a result of corporate failures. Technological change means information systems are capable of capturing, analysing and communicating significantly more data than previously. As a result, stakeholders are expecting the auditor to perform an audit that includes greater use of technology including DA.

Challenges that impact the use of Data Analytics

Data acquisition and retention – The entity's data will need to be transferred to the auditor raising concerns over data security and privacy as well as creating storage problems for such large data sets.

Conceptual challenges – Auditors will be asking questions they have never asked in the past and the client may be hesitant to provide all of the information requested.

Legal and regulatory challenges – Regulations may prohibit data leaving the jurisdiction the entity is located. This may pose a problem if the IT facilities of the client are located in a different country.

Resource availability – Data scientists may form part of a centralised department which supports all engagement teams within the firm. The resources are likely to be limited which will put a strain on resources.

How regulators and audit oversight authorities maintain oversight – These bodies have little experience themselves of inspecting audits using DA.

Investment in retraining and reskilling auditors – Changing the auditor's mind-set from traditional audit methods will require time and investment.

The use of DA and developments in auditing standards will impact:

Risk assessment – DA may improve the risk assessment process.

Quality control – Audit firms will need to consider how specialist teams are supervised and how they interact with the audit teams they support. Firms will need to consider the integrity of the DA software to ensure it does what it is supposed to.

Group audits – DA may help by enabling better analytical procedures to be performed in respect of components that are not significant components. Also, the audit procedures may be more centralised enabling the group auditor to perform more procedures rather than relying on the work of a component auditor.

Estimates and fair values – Due to large volumes of data that feed into the models used to develop accounting estimates, DA may be valuable in addressing audit risks associated with these data sources.

Smaller audit firms – Smaller firms may not be able to make the required investment to develop DA tools. Audits of public sector entities may prove challenging as home-grown systems are more prevalent and data capture may be more difficult.

Education – Auditors and accountants will need to be re-skilled to realise the potential of DA. Training and qualifications will need to reflect the increased use of DA for new entrants to the profession.

Ethics – Due to auditors having access to large volumes of client data, there may be a need to update the Code of Ethics to enhance the requirements for confidentiality.

Other auditing standards – There is also likely to be a need to revise other auditing standards such as ISA 240 (Fraud), ISA 320 (Materiality), ISA 330 (Responses to risks), ISA 500 (Audit Evidence), ISA 520 (Analytical Procedures) and ISA 530 (Audit Sampling).

FRC Audit Quality Thematic Review – The Use of Data Analytics in the Audit of Financial Statements

With the increasing use of data analytics, the FRC has performed a review to identify what is working well with a view of sharing information to promote continuous improvement in audit quality. The Audit Quality Review (AQR) team assessed the use of DA in the six largest audit firms.

Current use of data analytics

- Analyse all transactions in a population, stratify the population and identify outliers for further examination.
- Reperform calculations.
- Match transactions as they pass through the system.
- Assist in segregation of duties testing.
- Compare client data with externally obtained data.
- Perform sensitivity analysis.

Impact on audit quality

Audit quality is a driver for the implementation of DA. DA can:

- Deepen the auditor's understanding of the entity.
- Facilitate testing of the highest risk areas through stratification.
- Enhance the use of professional scepticism.
- Improve consistency on group audits.
- Enable the auditor to test entire datasets.
- Improve audit efficiency.
- Increase the possibility of identifying fraud.
- Provide a channel for enhanced communication with audit committees.

Good practices observed during the AQR

- Focused roll out of a DA tool.
- Clear positioning within the audit methodology.
- Testing or trial running the DA tool.
- Using specialist staff and clearly defined roles between the specialists and the core engagement team.
- Central running of DA for group audits.
- Clearly documenting the DA tool using flowcharts.

Summary of key findings

- The introduction of mandatory retendering in the UK has provided incentive for firms to develop DA tools as this acts as a key differentiator.
- UK firms are at the forefront of developing DA tools.
- The pace of change is not as fast as expected by audit committees and investors.
- Whilst some firms are investing heavily in DA tools, they are not monitoring their use by audit teams or effectiveness at providing appropriate evidence.
- Some audit teams have over-emphasised their use to audit committees. In some cases, DA have been used to provide insight to the audit committee rather than to generate audit evidence. In another case, a firm described a DA tool as launched in a report but was described to the Audit Quality Review team as being in pilot stage.
- All firms used DA to assist with journal entry testing, however, most firms are not using DA tools routinely in other audit areas.
- For complex entities it can take two years to achieve the full benefits of a DA approach.
- The main barrier to effective use relates to difficulties obtaining entity data and audit teams often lack expertise to extract the data required.
- The use of DA techniques was higher at firms where the audit methodology clearly defines the purpose of the DA.
- In the audits tested, insufficient evidence audit evidence was retained on file.
  - Criteria input into the DA tool was not retained.
  - Screenshots omitted important information.
  - Evidence produced by specialists was omitted.
  - Firm’s archiving tools were not able to archive DA evidence.
  - It may not be technically, practically or legally possible for the audit firm to retain audit evidence for the file retention period required by auditing standards.

Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics

In September 2016, IAASB issued a request for input from accounting firms, regulatory bodies, standard setters, academics and public sector organisations to obtain information about the current use and future direction of the use of data analytics.

The key messages from the Feedback Statement published in January 2018 are:

- ISAs are not 'broken' and should remain principles-based. There should be no rush to change requirements in ISAs at present.
- ISAs should be updated in a way that reflects current technology but remains technologically neutral to provide the ability to accommodate future changes in technology. ISA 500 *Audit Evidence* and ISA 230 *Audit Documentation* were highlighted as priorities for revision.
- Non-authoritative, practical guidance with real-life examples of the use of DA is needed. This process has already commenced.
- The use of DA does not reduce the need to exercise professional scepticism and judgement. Both are integral to understanding the benefits and limitations of using DA in the audit.

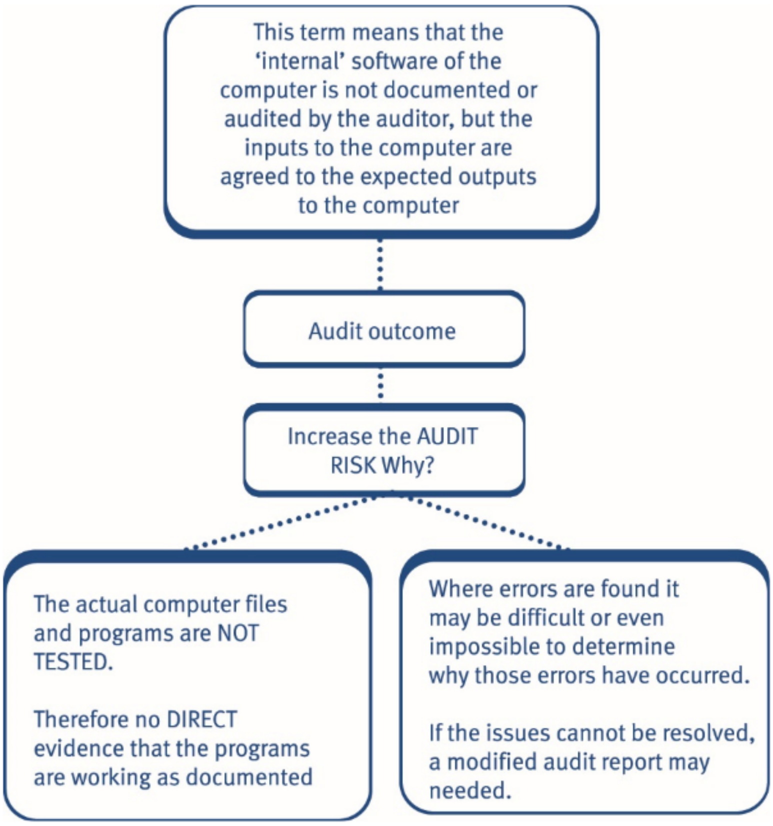
Areas of concern

Regulators and oversight authorities are most concerned with data acquisition, auditor skills and compliance with ISAs.

- Audit clients may be reluctant to give access to live systems and this may cast doubt on the reliability of the data being analysed.
- Currently auditors tend to have insufficient understanding of IT to design effective procedures using DA.
- Audit evidence generated from DA must demonstrate that the requirements of the ISAs have been met, particularly the documentation requirements.

Accounting firms are also concerned about retraining and re-skilling not only auditors, but also regulators and audit committees who will need to understand the DA performed as part of assessing the work of the auditor. There is also concern that these authorities have little experience themselves of inspecting audits involving the use of DA.

Auditing around the computer



Test your understanding 1

List FOUR factors that influence the reliability of audit evidence.

(4 marks)

Test your understanding 2

List and explain FOUR methods of selecting a sample of items to test from a population in accordance with ISA 530 *Audit Sampling*.

(4 marks)

Test your understanding 3

List and explain FOUR factors that will influence the auditor's judgement regarding the sufficiency of the evidence obtained.

(4 marks)

Test your understanding 4

You are assigned to the audit of Lamp Co. You are currently reviewing the audit work performed to date.

Tolerable deviation rate is 5%.

Tolerable misstatement is $3,000.

Tests of controls over revenue

During controls testing, the audit team tested a sample of 50 sales invoices for evidence of a second person checking the prices charged on the invoice to the company's approved price list, the goods invoiced to the goods despatched note and an arithmetical check of the invoice total. In four cases the checks had not been performed.

The sample was chosen by selecting every 37th invoice in the population.

Substantive procedures over purchases

During substantive testing, the audit team tested a sample of 50 purchase invoices from the detailed purchases listing and traced the amounts back to the physical invoices for accuracy. Two invoices were recorded inaccurately, resulting in a total misstatement within the sample of $198.

The total of the sample tested was $2,500. The total purchases figure included in the statement of profit or loss is $43,000.

The sample was chosen by the auditor selecting 50 invoices from anywhere in the detailed purchases listing, trying to avoid bias.

1 **In respect of the tests of controls over revenue, which TWO of the following are appropriate responses?**

(i) Pick alternative items to test in place of those just tested and ignore the deviations.

(ii) Extend the sample size.

(iii) Perform increased substantive testing.

(iv) Extrapolate the deviation across the population.

A (i) and (ii)

B (ii) and (iii)

C (i) and (iv)

D (iii) and (iv)

2 **In respect of the substantive testing performed over purchases, what action should the auditor now take?**

A Inform the client of the misstatement and ask them to correct it

B Calculate the materiality of the misstatement in relation to the financial statements

C Extend the sample

D Compare the misstatement with the tolerable deviation rate

3 **Select the sampling method used in each of the procedures stated.**

Test of controls over revenue	**Haphazard**	**Random**	**Systematic**
Substantive procedure over purchases	**Haphazard**	**Random**	**Systematic**

4 **Which of the following statements is TRUE?**

A Sampling refers to where less than 100% of the items in a population are tested and have an equal chance of selection

B Deviations must be extrapolated to determine the effect on the population

C Block sampling is where the auditor tests all items in a population

D Monetary unit sampling is a statistical method of sampling

5 **Select whether the following statements are TRUE or FALSE.**

Statistical sampling methods are more reliable than non-statistical methods	**TRUE**	**FALSE**
The auditor must always use stratification to ensure a representative sample is tested	**TRUE**	**FALSE**
More than one sampling method may be used to test one population	**TRUE**	**FALSE**
A deviation occurs when a result differs from expectation during a substantive procedure	**TRUE**	**FALSE**

Test your understanding 5

You are planning the audit of Wyndham Co. The company sells diamonds and other precious stones. You have decided to use the work of an auditor's expert to provide sufficient appropriate evidence over the valuation of inventory.

1 **Before appointing an auditor's expert, what factors must the auditor consider?**

(i) Competence

(ii) Capability

(iii) Objectivity

(iv) Reliability of the source data

A (i), (ii) and (iii)

B (ii), (iii) and (iv)

C (i) (iii) and (iv) only

D (i), (ii), (iii) and (iv)

2 **How can the auditor assess the competence of an auditor's expert?**

(i) Obtain copies of professional certificates and make enquiries of the expert's experience.

(ii) Ask for confirmation from the expert of their independence.

(iii) Inspect the register of members of the relevant professional body for the name of the expert.

A (i) and (ii) only

B (ii) and (iii) only

C (i) and (iii) only

D (i), (ii) and (iii)

3 **What must be agreed with the auditor's expert in writing before the work is performed?**

(i) Responsibilities of each party

(ii) Inherent limitations of the audit

(iii) Deadline for the work

(iv) Scope and objectives

A (i), (ii), (iii) and (iv)

B (i), (iii) and (iv) only

C (iii) and (ii) only

D (i), (ii) and (iv) only

4 **Which of the following statements is TRUE in respect of the expert's work?**

A The auditor can rely on the expert's work and does not need to review it

B The auditor may choose not to review the expert's work if it is an area in which the auditor has knowledge or experience

C The auditor must review the assumptions and source data used by the expert to ensure they were reasonable and reliable

D The auditor will engage a second expert to review the work of the first to ensure sufficient appropriate evidence has been obtained

5 **Which of the following statements best describes a management's expert?**

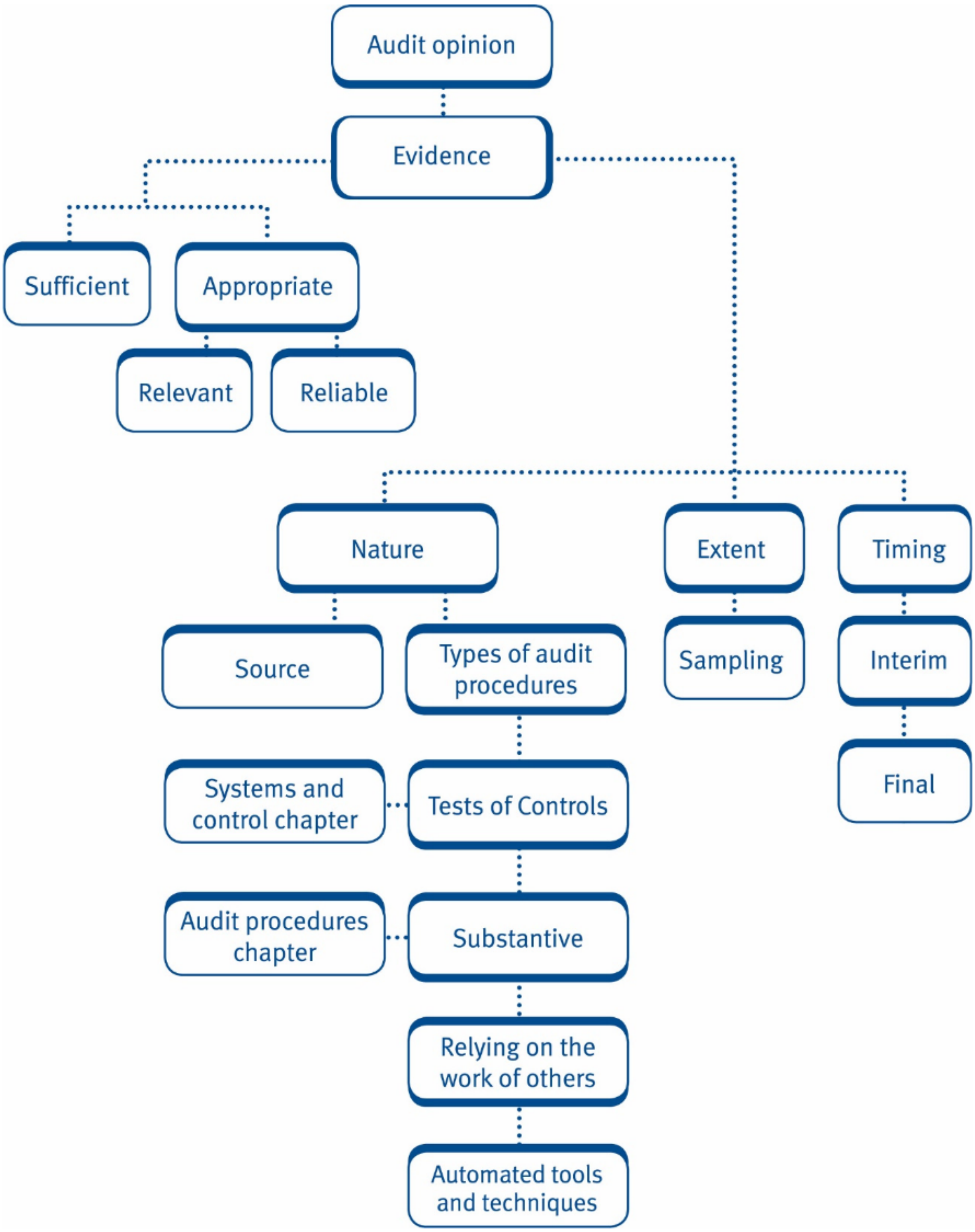
A A management's expert is an employee of the company

B A management's expert is someone appointed by the company to provide evidence for the auditor

C A management's expert is someone recommended by the auditor which management appoints to provide evidence for the audit

D A management's expert is someone appointed by the company to provide evidence for management which may be relied upon by the auditor

8 Chapter summary



Test your understanding answers

Test your understanding 1

Reliability of audit evidence [ISA 500, A31]

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. (For example, notes of a meeting taken during the meeting are more reliable than a subsequent oral representation of the matters discussed.)
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles (fax).

Only four examples are required.

Test your understanding 2

Sampling methods [ISA 530, Appendix 4]

Methods of sampling in accordance with ISA 530:

- **Random** selection. Ensures each item in a population has an equal chance of selection, for example by using random number tables.
- **Systematic** selection. In which a number of sampling units in the population is divided by the sample size to give a sampling interval.
- **Haphazard** selection. The auditor selects the sample without following a structured technique – the auditor would avoid any conscious bias or predictability.
- **Block** selection. Involves selecting a block(s) of contiguous items from within a population.
- **Monetary unit sampling.** This selection method ensures that each individual $1 in the population has an equal chance of being selected.

Note: Only four sampling methods were required.

Test your understanding 3

Sufficiency of evidence

- Assessment of risk at the financial statement level and/or the individual transaction level. As risk increases then more evidence is required.
- The materiality of the item. More evidence will normally be collected on material items whereas immaterial items may simply be reviewed to ensure they appear materially correct.
- The nature of the accounting and internal control systems. The auditor will place more reliance on good accounting and internal control systems reducing the amount of substantive evidence required.
- The auditor's knowledge and experience of the business. Where the auditor has good knowledge of the business and trusts the integrity of staff then less evidence will be required.
- The findings of audit procedures. Where findings from related audit procedures are satisfactory (e.g. tests of controls) then less substantive evidence will be collected.
- The source and reliability of the information. Where evidence is obtained from reliable sources (e.g. written evidence) then less evidence is required than if the source was unreliable (e.g. verbal evidence).

Test your understanding 4

1	B	Extend the sample size and perform more substantive tests. The auditor should never disregard deviations or misstatements identified during testing. It is not appropriate to extrapolate a deviation rate across a population.
2	C	The misstatement must be extrapolated across the population. 198/2,500 × 43,000 = $3,406. This exceeds tolerable misstatement of $3,000 therefore the auditor must perform further audit procedures by extending the sample.
3	Systematic Haphazard	Tests of control over revenue have used systematic sampling. This is when a constant sampling interval is used e.g. every 37th item. Substantive procedures over purchases have used haphazard sampling. This is when the auditor selects the sample without a pattern and tries to avoid bias.
4	D	Sampling is when each item in a population has a chance of selection. They do not need to have an equal chance. Deviations are not extrapolated as the deviation rate will be the same across the population. Block sampling is where items next to each other in the population are tested.
5	False False True False	Statistical sampling methods are not necessarily more reliable than non-statistical methods. The auditor must use professional judgement to choose whichever is appropriate in the circumstances. Stratification should be used when a population is not homogenous. If the population is homogenous, stratification will not be necessary. More than one sampling method may be used to test the same population. If the population has been stratified, the auditor may use different sampling methods for each sub-population. A deviation occurs when a result differs from expectation when the auditor performs tests of controls.

Test your understanding 5

1	A	Reliability of source data is evaluated after the expert has performed the work.
2	C	An independence confirmation from the expert would confirm objectivity but not competence.
3	B	Inherent limitations of an audit would not be communicated to the expert. This would be included in an audit engagement letter.
4	C	The auditor cannot just rely on the expert's work. They must review it to ensure it provides sufficient appropriate evidence and therefore must consider the assumptions and source data. If the auditor already had knowledge and experience in this area there would be no need to use an auditor's expert. If the auditor has evaluated the competence, capability and objectivity of the expert before using them, there should be no need to appoint a second expert to the review the first expert's work.
5	D	A management's expert is appointed by management to produce evidence to be used by management. If the evidence is reliable and relevant to the external audit, the auditor may choose to rely on that work.

Chapter

8

Systems and controls

Chapter learning objectives

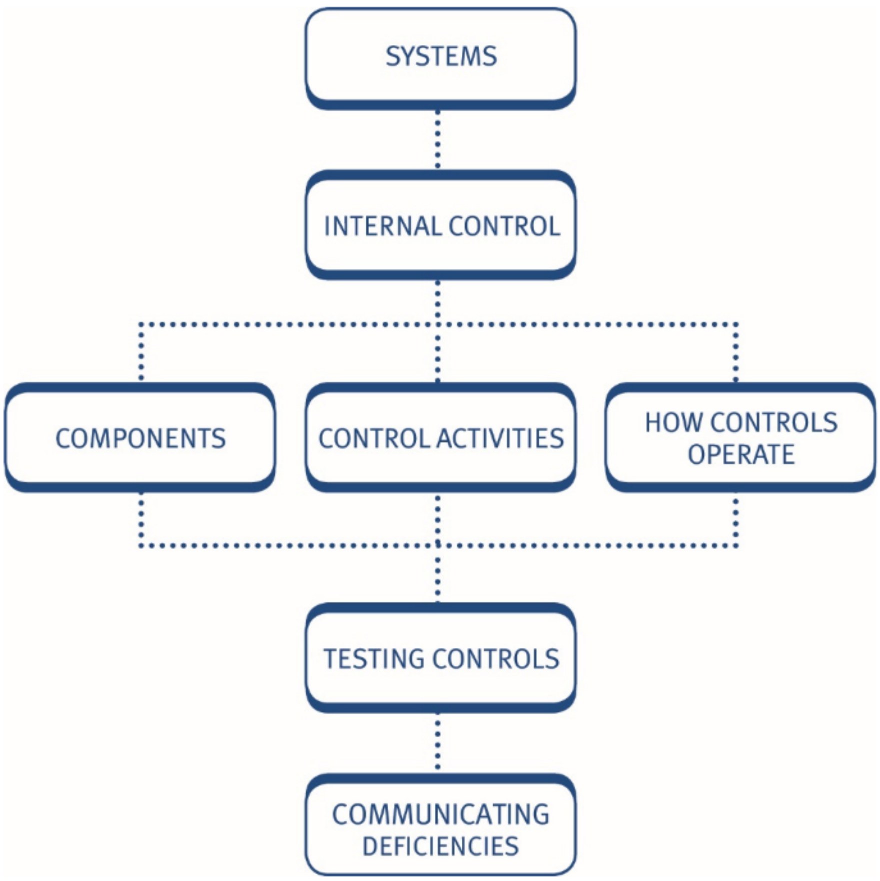
This chapter covers syllabus areas:

- C1 – Systems of internal control
- C2 – The use and evaluation of systems of internal control by auditors
- C3 – Tests of controls
- C4 – Communication on internal control

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO19) is to collect and evaluate evidence for an audit. Carry out an internal or external audit from collecting evidence, through to forming an opinion. You demonstrate professional scepticism and make sure judgements are based on sufficient valid evidence. Working through this chapter should help you understand how to demonstrate that objective.



The basics of an internal control system were covered in Business Technology (previously Accountant in Business) at the Applied Knowledge level. This chapter develops this area further and looks at how the client's system of internal control influences the audit approach taken and the audit evidence gathered.

1 Effect of controls on the audit

This chapter considers the basic components of an internal control system, and how the auditor fulfils their objectives for assessing control risk.

As we saw in Chapter 5, control risk is one of the factors affecting the risk of material misstatement. If a client's system of internal control is designed appropriately, implemented and working effectively, there will be less risk of material misstatement in the financial statements as the controls will have either prevented the misstatements from occurring in the first place, or will have detected the misstatements and prompted action for them to be corrected. The auditor will use this assessment of control risk to determine the impact on the audit strategy and audit plan.

Impact of tests of controls on the audit strategy and plan

The extent of substantive testing to be carried out will depend on the results of the auditor's assessment of control risk.

If control risk is low

- The auditor can **place more reliance on internal controls** and evidence generated internally within the entity.
- This increases the appropriateness of interim audit testing and allows the auditor to **reduce the quantity of detailed substantive procedures** performed at the final audit stage.
- The audit strategy and plan will be updated to reflect that fewer substantive procedures will be required or smaller sample sizes can be tested at the final audit stage.

If control risk is high

The auditor will:

- Increase the volume of procedures conducted at and after the year end. [ISA 330, A2]
- Increase the level of substantive procedures, in particular, tests of detail. [ISA 330, A2]
- Increase the locations included in the audit scope. [ISA 330, A2]
- Place less reliance on analytical procedures as the information produced by the client's systems is not reliable.
- Place less reliance on written representations from management if the control environment is weak.
- Obtain more evidence from external sources e.g. external confirmations from customers and suppliers.
- Update the audit strategy and plan to reflect the additional testing required at the final audit stage.

Limitations of internal controls

The auditor can never eliminate the need for substantive procedures entirely because there are inherent limitations to the reliance that can be placed on internal controls due to:

- Human error – mistakes made by those responsible for performing controls.
- Ineffective controls – controls which do not work as intended.
- Collusion of staff – staff work together (collude) to bypass the control of segregation of duties.

- The abuse of power by those with ultimate controlling responsibility (management override) − management may falsify accounting records or post unauthorised journals to present a different result in the financial statements.
- Use of management judgement on the nature and extent of controls it chooses to implement.

[ISA 315 (Revised 2019), Appendix 3, 22 – 24]

As a result of these limitations, the auditor must always perform substantive testing on material balances in the financial statements. [ISA 330, 18]

e.g

Examples of control limitations

Human error

Warehouse staff are required to check the quantity of the goods received to the authorised purchase order however an error may be made when counting.

Ineffective controls

The sales manager is required to authorise the mileage claims of sales representatives within their department. The authorisation process should include a check that the mileage claimed is reasonable however the department manager performs no checks and simply signs off the claim as authorised.

Collusion

Within the payroll department, a payroll clerk processes timesheets and overtime claims and the payroll manager authorises the payroll for payment, however the clerk and manager are related and collude to enable the clerk to increase the overtime paid to themselves.

Management override

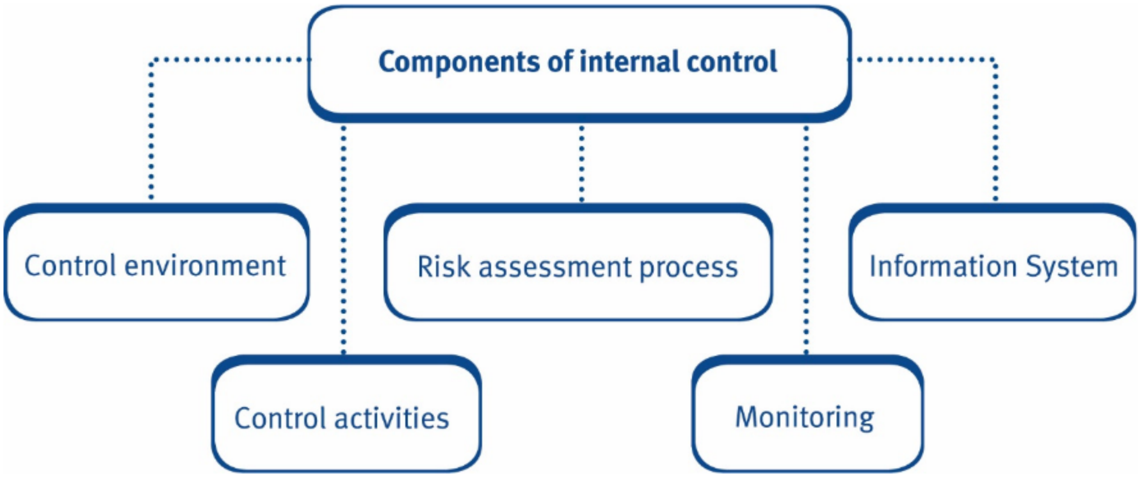
During the preparation of the financial statements, the finance director falsifies the accounting records by posting a journal to increase revenue to show a desired level of profit required to meet a loan covenant.

Use of management judgement

Last year's report to management contained several recommendations for improvements to the client's controls which exposed the company to fraud and error. During the current year audit the audit manager identified that no action had been taken in response to the recommendations. When the matter was discussed with the finance director, the audit manager was told that the cost of implementing the controls outweighed the benefits and therefore the company would not be acting on the recommendations.

2 Components of internal control

ISA 315 (Revised 2019), states that the auditor needs to understand an entity's internal controls. To assist this process, it identifies five components:



[ISA 315 (Revised 2019),12m]

(i) The control environment

The control environment includes the **governance and management** function of an organisation.

It focuses largely on the **attitude, awareness and actions** of those responsible for designing, implementing and monitoring internal controls.

The control environment sets the tone of an organisation and provides the foundation for the other components of the entity's system of internal control.

[ISA 315 (Revised 2019), Appendix 3, 4]

Elements of the control environment:

- How management's responsibilities are carried out, demonstrating management's commitment to integrity and ethical values.
- How those charged with governance demonstrate independence from management and exercise oversight of the system.
- How the entity assigns authority and responsibility in pursuit of its objectives.
- How the entity attracts, develops and retains competent people including recruitment policies, training policies and performance appraisals.
- How the entity holds individuals accountable for their responsibilities e.g. performance measures and disciplinary policies.

[ISA 315 (Revised 2019), Appendix 3, 6]

When assessing the control environment, the auditor may consider how management has responded to the findings and recommendations of the internal audit function regarding identified control deficiencies.

The auditor must also assess whether any controls implemented as a result of those recommendations have been subsequently evaluated by the internal audit function. [ISA 315 (Revised 2019), Appendix 4, 7]

Evidence regarding the control environment is usually obtained through a mixture of enquiry and observation, although inspection of key internal documents (e.g. codes of conduct and organisation charts) is possible.

(ii) The entity's risk assessment process

The auditor must obtain an understanding of the entity's process for identifying business risks relevant to financial reporting, assessing the significance of those risks and addressing those risks. The auditor must then evaluate whether the process is appropriate to the entity's circumstances taking into consideration the nature and complexity of the entity. [ISA 315 (Revised 2019), 22]

The risk assessment process forms the basis for how management determines the risks to be managed. However, the auditor is only interested in the business risks relevant to the preparation of the financial statements.
[ISA 315 (Revised 2019), Appendix 3, 7, 8]

Business risks relevant to financial reporting are threats to the achievement of ongoing business objectives and can lead to misstatement in the financial statements.

Examples include:

- New information systems and technology
- Rapid growth
- New accounting requirements/principles
- Maintaining the integrity of data and information processing
- Risks to the entity's business strategy if the entity's IT strategy does not effectively support the business strategy
- Interruptions in the IT environment when the entity does not make necessary updates to the IT environment or such updates are not timely.

[ISA 315 (Revised 2019), Appendix 3, 9]

If the client has robust procedures for assessing the business risks it faces, the risk of misstatement overall will be lower.

If the auditor identifies instances where management failed to identify risks of material misstatement, they should obtain an understanding of why the entity's process failed to identify the risks and consider the implications for the audit.
[ISA 315 (Revised 2019), 23]

(iii) The entity's process to monitor the system of internal control

This is the client's continual process of evaluating the effectiveness of controls over time and taking necessary remedial action.

Monitoring can be either ongoing or performed on a separate evaluation basis (or a combination of both).

[ISA 315 (Revised 2019), Appendix 3, 10]

Monitoring of internal controls is often the key role of the internal audit function.

(iv) The information system and communication

The information system relevant to financial reporting consists of all of the activities and policies relevant to financial reporting and communication. It includes the procedures within both computerised and manual systems.

The information system includes all of the procedures and records which are designed to:

- Initiate, record, process and report transactions.
- Maintain accountability for assets, liabilities and equity.
- Resolve incorrect processing of transactions.
- Process and account for system overrides.
- Transfer information to the general ledger.
- Capture information relevant to financial reporting for other events and conditions.
- Ensure information required to be disclosed is appropriately reported.

[ISA 315 (Revised 2019), Appendix 3, 15]

(v) Control activities

Control activities are the policies (statements of what should or should not be done) and procedures (actions to implement policies) to achieve the control objectives of management and those charged with governance.

Examples of specific control activities include those relating to:

- Authorisation to confirm the validity of a transaction.
- Reconciliations to address the completeness or accuracy of transactions.
- Verifications to address the completeness, accuracy or validity of transactions.
- Physical or logical controls to prevent theft of assets or data.
- Segregation of duties to reduce opportunity for any person to commit and conceal fraud in the normal course of their duties.

[ISA 315 (Revised 2019), Appendix 3, 20]

Tutorial note

A control objective identifies the risk that the entity needs to manage i.e. the reason for a control procedure or activity being required.

For example, a risk within a purchasing system is that purchases could be made for personal use and paid by the company. Therefore, the control objective is to ensure goods cannot be purchased for personal use.

Most companies would have a control procedure in place to prevent this risk from occurring, such as authorisation of purchase orders by a responsible official.

Examples of control activities

Authorisation

- A manager signing off an employee's timesheet to confirm that the hours stated have been worked and can be paid. This should ensure the employee is not claiming for hours not worked.
- A manager signing a purchase order to confirm the order can be placed with the supplier. This should ensure that the goods are for a valid business use and the items are needed.

Reconciliation

- Preparation of a bank reconciliation to ensure cash transactions have been recorded completely and accurately.
- Reconciliation of supplier statements with the list of individual suppliers to ensure completeness and accuracy of payables.

Verification

- Managers should compare actual spend against budgeted spend to detect unusual fluctuations. If actual spend is significantly higher than budget, the department may have spent more than it should or it could indicate an error when processing the transactions.
- Batch totals used when inputting data to ensure items are not omitted.

Physical or logical controls

- Restrictions on access to assets such as keeping cash in a safe to prevent theft.
- Password restrictions to prevent unauthorised access to computer files.

Segregation of duties

- Warehouse staff should not be responsible for the inventory count as this would not detect if goods were being stolen by staff throughout the year.
- Employees who authorise transactions should not be the ones who originate the transaction.

Controls may be **direct or indirect**. A direct control addresses the risk of material misstatement at the assertion level. [ISA 315 (Revised 2019), A5]

For example, a manager's review of the payroll total each month to ensure the amount to be paid is in line with expectation is an indirect control as it does not specifically address an assertion. Agreeing the amounts on the payroll list to individual payslips would address the assertion of accuracy and is therefore a direct control.

Indirect controls support the direct controls. The general IT controls given below are examples of indirect controls.

e.g

Examples of direct controls

Sales

A credit check on a customer reduces the risk of sales being made to a customer who may be unable to pay thereby reducing the risk of irrecoverable debts. This reduces the risk of misstatement of receivables.

Purchases

Purchase requisitions and orders must be approved before being placed with a supplier. Authorisation ensures the purchase is for a valid business use reducing the risk of fraudulent purchases being made. Purchases will be misstated if a fraudulent purchase is made as it will not pertain to the entity and therefore will not have occurred.

Payroll

The payroll software calculates payroll amounts and a payroll supervisor performs a sample check of calculations to ensure accuracy. The sample check reduces the risk of misstatement of the payroll expense.

Inventory

Rotation of inventory in the warehouse ensures the oldest inventory is sold first which means there is less chance of perishable items going out of date before being sold. This reduces the risk of inventory needing to be scrapped which could cause misstatement if inventory is not valued appropriately.

Non-current assets

A unique serial number is assigned to each asset and recorded on the asset register which enables the entity to ensure completeness.

IT controls

The level of risk arising from the IT environment will vary from client to client depending on the nature and extent to which the entity uses technology. More complex IT systems may involve the use of emerging technologies such as blockchain, or may involve the client changing the source code of the program. Less sophisticated systems may simply be a user interface in which the client enters data which the system processes.

Regardless of the scale of complexity, the auditor must always identify the IT application and other aspects of the entity's IT environment that are subject to risks arising from the use of IT and identify the related risks arising from the use of IT and the general controls in place to address those risks.
[ISA 315 (Revised 2019), 26]

IT controls are normally divided into **general** controls and **information processing** controls. An effective IT system should include both.

General controls

General IT controls support the continued proper operation of the IT environment, including effective functioning of the information processing controls and the integrity of information in the information system. [ISA 315 (Revised 2019), 12d]

E.g. controls over:

- Access − Preventing unauthorised access to applications, databases, operating system, networks.
- Program changes or other changes to the IT environment – Segregation of duties, system development, data conversion.
- Process to manage IT operations – job scheduling, job monitoring, backup and recovery, intrusion detection.

[ISA 315 (Revised 2019, Appendix 6, 2]

Information processing controls

Information processing controls relate to the processing of information in IT applications or manual processes that directly address risks to the integrity of information. [ISA 315 (Revised 2019), 12d]

These controls may be automated (embedded in IT applications) or manual (e.g. input or output controls). [ISA 315 (Revised 2019), A6]

Examples include:

- Batch total checks (e.g. when entering invoices onto the system the system may give a batch total i.e. the number of invoices actually entered. The clerk entering the invoices can then double check that the correct number of invoices has been entered and none have been missed or entered twice).

- Sequence checks (to ensure the number sequence is complete and no items are missing).
- Matching master files to transaction records (e.g. matching prices on sales invoices to the company's price list to ensure the prices being applied are correct).
- Arithmetic checks (to verify arithmetical accuracy).
- Range checks (to ensure that data entered is within a reasonable range).
- Existence checks (e.g. to check employees exist).
- Authorisation of transaction entries (to ensure the transaction is valid and should be processed).
- Exception reporting (the system may generate an exception report when something which isn't usual has occurred e.g. changes to bank details of employees which wouldn't be expected to change often).

3 Ascertaining the systems

Procedures used to obtain evidence regarding the design and implementation of controls include:

- Enquiries of relevant personnel.
- Observing the application of controls.
- Tracing a transaction through the system to understand what happens (a walkthrough test).
- Inspecting documents, such as internal procedure manuals.

It should also be noted that enquiry alone is not sufficient to understand the nature and extent of controls.

The auditor can also use existing knowledge of the client and the operation of the systems. However, they cannot simply rely on their knowledge from the prior year audit as changes may have occurred. Systems knowledge must be updated and the systems tested once more if it relates to an area of significant risk. For controls which do not address a significant risk, the auditor must test the controls at least once every third audit. [ISA 330, A37]

4 Documenting client's systems

The auditor must document the client's control systems before evaluating whether the system is adequate and working effectively.

Possible ways of documenting systems include:

- **Narrative notes** – a written description of a system.
- **Flowcharts** – a diagrammatical representation of the system.
- **Questionnaires** – a prepared list of questions in relation to the client's control system. There are two types of questionnaire that can be used:

  Internal Control Questionnaire (ICQ) – a list of controls is given to the client and they are asked whether or not those controls are in place.

  Internal Control Evaluation Questionnaire (ICEQ) – the client is asked to describe the controls they have in place for a given control objective.

- **Organisation chart** – a diagram showing reporting lines, roles and responsibilities.

ICQ wording	ICEQ wording
Does a supervisor authorise all weekly timesheets?	How does the company ensure that only hours worked are recorded on timesheets?
Does the company perform a regular credit check on all customers?	How does the company try to minimise the risk of irrecoverable debts?
Does a manager or director authorise purchase orders before an order is placed?	How does the company ensure goods are only purchased for a valid business use?
Is a bank reconciliation performed regularly?	How does the company ensure discrepancies in the bank ledger account are identified and resolved?
Is a regular inventory count performed?	How does the company ensure its inventory system is up to date and discrepancies in the inventory records are identified and corrected?
Is a regular reconciliation performed between the physical non-current assets and the non-current asset register?	How does the company ensure the non-current asset register is up to date and accurate?

The method adopted is a matter of auditor judgement.

Documentation Method	Advantages	Disadvantages
Narrative notes	• Simple to record • Facilitates understanding by all audit staff	• May be time consuming and cumbersome if the system is complex • May be more difficult to identify missing controls
Flow charts	• Easy to view the whole system in one diagram • Easy to spot missing controls due to the use of standard symbols	• May be difficult to amend as the whole diagram may need to be re-drawn • There is still a need for narrative notes to accompany the flow chart increasing the time involved to document the system fully
Internal control questionnaires (ICQs)	• Quick to prepare as a standard questionnaire can be used for all clients • Can ensure all common controls are present	• Controls may be overstated as the client knows the answer the auditor is looking for is 'yes' • Unusual controls are unlikely to be included on a standard questionnaire and may not be identified • May contain a number of irrelevant controls
Internal control evaluations (ICEs)	• The client has to respond with the control they have in place rather than a yes/no answer which should mean controls are less likely to be overstated • Quick to prepare	• The client may still overstate controls as they may say a control is in place for the control objective even if it is not • The checklist may contain control objectives not relevant to the client • Unusual risks and therefore objectives may not be identified

5 Testing the system

Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct a material misstatement in a relevant assertion. [ISA 330, A20]

Controls will only be worth testing if they are designed appropriately in the first place (i.e. they are capable of preventing or detecting and correcting misstatements) and implemented (i.e. the controls exist and the entity is using them). When a control is not designed or implemented effectively, there is no benefit in testing it. [ISA 315 (Revised 2019), A175, A176, A179]

Typical methods of controls testing include:

- Observation of control activities, e.g. observing the inventory count to ensure it is conducted effectively and in accordance with the count instructions.
- Inspection of documents recording performance of the control, e.g. inspecting an order for evidence of authorisation.
- Using test data to ensure the programmed controls are working effectively. See the 'Evidence' chapter).

Designing valid tests of controls

To design a test of control, the auditor must first identify the controls they want to test.

A control is an activity applied in addition to the normal processing of the system to ensure that the system has operated as it should.

Just because errors have not been made does not mean that controls have worked effectively. The person performing the processing may not have made any errors. There may have been no controls in place. A control is an additional activity to ensure the person has not made any errors.

For example, if the client claims to perform bank reconciliations, the auditor should look at the file containing the reconciliations to verify that they are done, and then reperform the reconciliation to ensure it has been done properly, to test the effectiveness of the control. Simply performing the reconciliation and finding that it reconciles does not prove that the client has done the reconciliation themselves. Therefore, reperformance of the reconciliation on its own is not a valid test of control.

Similarly, if the auditor performs a sequence check on a set of documents and finds the sequence is complete, it does not mean the client has performed a sequence check. It may just mean that no documents have gone missing. The auditor must look for evidence that the client has performed a sequence check to confirm no documents have gone missing.

6 Communicating control deficiencies

ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* requires the auditor to:

- Communicate any deficiencies that are of sufficient importance to merit management's attention to management. [ISA 265, 10]
- Communicate significant deficiencies to those charged with governance. [ISA 265, 9]

Deficiencies occur when:

- A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct misstatements in the financial statements on a timely basis, or
- A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

[ISA 265, 6a]

Significant deficiencies are those which merit the attention of those charged with governance. [ISA 265, 6b]

The external auditor should consider the following when determining if a deficiency in internal controls is significant:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process.
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

[ISA 265, A6]

Report to management/management letter

The auditor will communicate the deficiencies in a report to management or management letter. It is usually sent at the end of the audit and comprises a covering letter with an appendix containing the deficiencies the auditor has found within the client's control system(s) and recommendations to overcome each deficiency.

The **covering letter** will state that the control deficiencies identified during the audit are included in the appendix and will clarify that:

- The report is not a comprehensive list of deficiencies, but only those that have come to light during normal audit procedures.
- The report is for the sole use of the company.
- No disclosure should be made to a third party without the written agreement of the auditor.
- No responsibility is assumed to any other parties.

e.g

Covering letter for a report to management

Board of directors
Murray Co
1 Murray Mound
Wimbledon
WN1 2LN

1 July 20X5

Dear Sirs,

Audit of Murray Co for the year ended 31 December 20X4

Please find enclosed the report to management on deficiencies in internal controls identified during the audit for the year ended 31 December 20X4. The appendix to this report considers deficiencies in the purchasing and payments system, the implications of those deficiencies and recommendations to address those deficiencies.

Please note that this report only addresses the deficiencies identified during the audit and if further testing had been performed, then more deficiencies may have been reported.

This report is solely for the use of management and if you have any further questions, then please do not hesitate to contact us.

Yours faithfully

An audit firm

The **appendix** will set out the following:

Deficiency and consequence	**Recommendation**
A clear description of what is wrong. What could happen if the deficiency is not corrected? Focus on what matters to the client – the risk of a reduction in revenue, extra costs, stolen assets, errors in the accounts.	This must deal with the specific deficiency you have identified. It must also provide greater benefits than the cost of implementation. Try to specify exactly how the recommended control should operate, for example, suggest who should carry out the control procedure, and how frequently it should be performed.

e.g

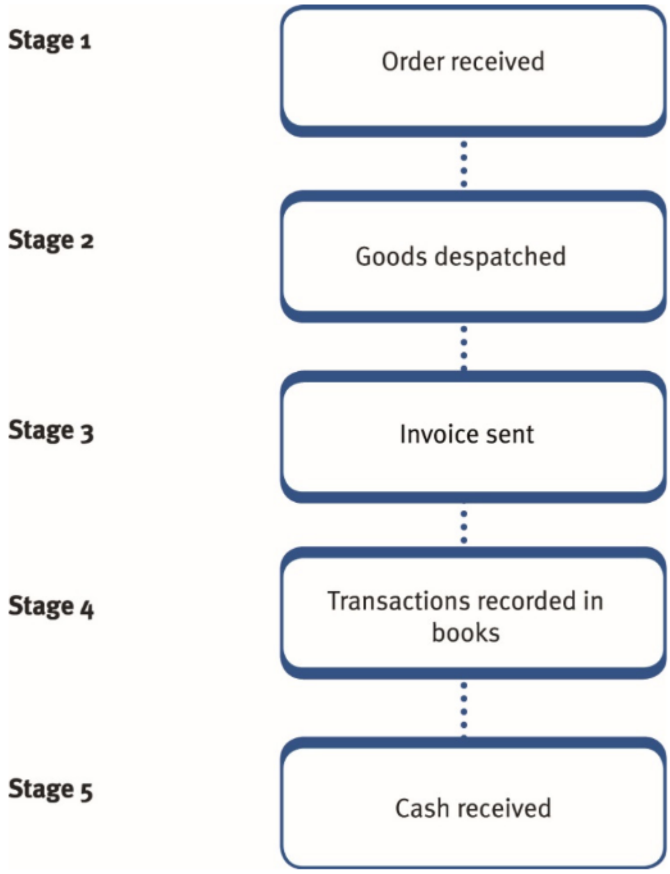
Appendix – Report to management

Control deficiency	**Recommendation**
Purchase invoices were missing from the sequentially numbered invoice file. There is a possibility that purchases and liabilities are not completely recorded. This could result in late payment of invoices which could cause damage to the company's relationship with the supplier resulting in removal of credit terms or discounts.	All invoices should be sequentially filed on receipt by the accounts department. Regular sequence checks should be performed to ensure completeness. Any missing items should be investigated and copies requested if necessary.

In the exam you may be required to prepare **extracts for inclusion** in a report to management. This requires you to only prepare the appendix, in a table format, as shown above.

If you are also asked for a covering letter, you must produce a letter, as shown in the example above, as well as the appendix. There will be additional marks awarded for the covering letter.

7 Sales system



Objectives

The objectives of controls in the sales system are to ensure that:

Stage	Objective
Ordering	• Goods are only supplied to customers who pay promptly and in full. • All orders are processed.
Despatch	• Orders are despatched promptly and in full to the correct customer. • All orders are despatched.
Invoicing	• All goods despatched are invoiced. • Invoices are raised accurately.

Recording	• Only valid sales are recorded. • All sales and related receivables are recorded and in the correct accounts. • Revenue is recorded in the period to which it relates. • Sales are recorded accurately and related receivables are recorded at an appropriate value.
Cash received	• Cash received is allocated against the correct customer and invoices to minimise disputes. • Overdue debts are followed up on a timely basis. • Irrecoverable debts are identified and written off appropriately.

Test your understanding 1

Murray case study: Sales cycle

Ordering

For all new customers, a sales manager completes a credit application which is checked with a credit agency and a credit limit is entered into the sales system by the credit controller. Credit checks are not reperformed unless a customer requests an increase to their credit limit. If an increase is requested, a new check will be performed and the credit limit revised.

The orders are entered into the sales system by a sales assistant. After the order has been accepted, the sales assistant checks that the goods are available and that the order will not take the customer over their credit limit.

Goods despatch

When the warehouse receives the order, a goods despatch note (GDN) is generated and a member of the warehouse team packs the goods using the GDN. A second member of the team double checks the details on the GDN to the goods packed, signing the GDN to evidence the check.

Four copies of the GDN are produced. One copy is sent with the goods and retained by the customer. A second is sent with the goods, signed by the customer and returned to Murray Co to confirm receipt of the goods which is filed in the warehouse. A third copy is sent to the sales team who update the system and the fourth copy is sent to the accounts department.

Invoicing

Sales invoices are raised by the accounts department using the GDNs. Sales invoices are not sequentially numbered, and no review is performed to ensure all goods have been invoiced.

Sales invoices are prepared using the approved company price list, which is updated quarterly. Payment terms are stated on the sales invoice and all customers have 10 days to pay their invoice.

Discounts must be requested by a sales manager and authorised by the sales director to allow the accounts team to raise an invoice.

Recording transaction

The list of individual customers is reviewed for credit balances by the senior accountant on a monthly basis and reconciled with the trade receivables account when the sales ledger manager has time. Monthly customer statements are sent to customers.

Cash receipt

Receipts are counted by the office assistant, recorded by the cashier in the bank ledger account, and the sales ledger clerk is notified of the receipt. The sales ledger clerk agrees the amount received to the amount invoiced and marks the invoice as paid.

The credit controller reviews the aged receivables analysis on a fortnightly basis to assess the level of slow-moving debts and an allowance is made for any debts which are considered doubtful. Debts which are more than six-months overdue are chased up.

Required:

In respect of the sales system of Murray Co:

(a) (i) Identify and explain FIVE DIRECT CONTROLS which the auditor may seek to place reliance on; and

(ii) Describe a TEST OF CONTROL the auditor should perform to assess if each of these controls is operating effectively.

Note: Prepare your answer using two columns headed Direct control and Test of control respectively. **(10 marks)**

(b) Identify and explain FIVE DEFICIENCIES and provide a recommendation to address each of these deficiencies.

Note: Prepare your answer using two columns headed Control deficiencies and Control recommendation respectively. **(10 marks)**

(Total: 20 marks)

Illustration 1 – Murray Co goods despatch note

The key document in the sales cycle is the goods despatch note:

Murray Co

Goods Despatch Note

"Supplying Equipment to the Sporting Nation"

Ref: AB123456MC

www.murraysports.com

Murray Co

1 Murray Mound,
Wimbledon, London
WN1 2LN

Destination

Customer Ref: W004

Order Number: ZY987654WS

Customer Name: Winners Co

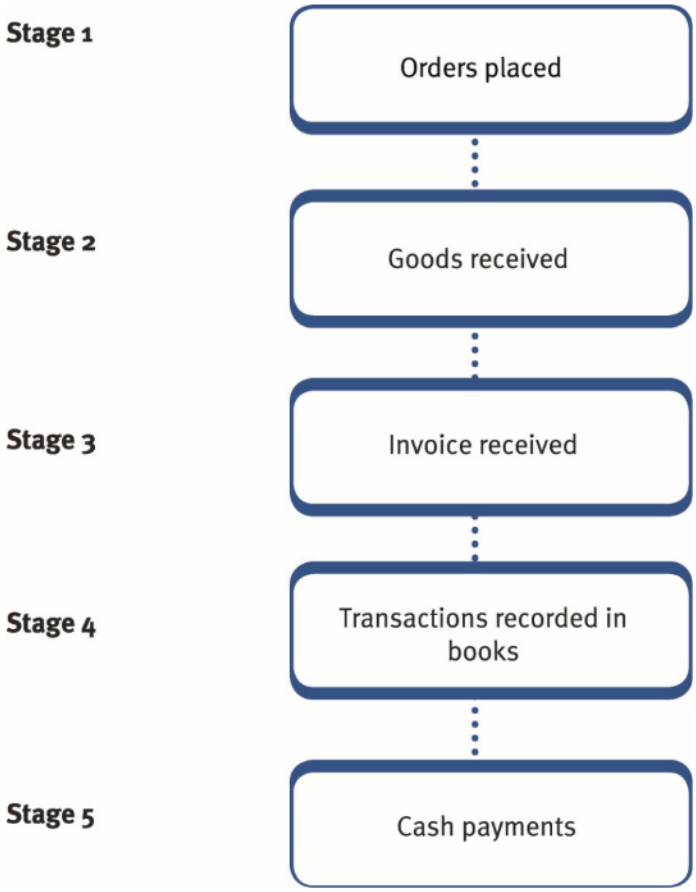
Customer Address: 2 Edinburgh St, Dunblaine, Scotland DL2 2ES

Line	Product Number	Description	Quantity	Quantity Quality and quantity of goods checked and agreed
001	4378493729	Tennis racket	24	Yes
002	3257845743	Tennis balls (packs of 6)	6	Yes
003	4357849574	Tennis court net	3	Yes
004	3473895789	Tennis scoreboard	3	Yes
005	4574895743	Winner's trophy	1	Yes
006	3457435437	Runner-up trophy	1	Yes
007	4830998543	Participant's medal	24	Yes

Signed:

A Warehouse Packer

8 Purchase system



Objectives

The objectives of controls in the purchases system are to ensure that:

Stage	Objective
Ordering	• All purchases are made with suppliers who have been checked for quality, reliability and pricing. • Purchases are only made for a valid business use. • Orders are placed taking consideration of delivery lead times to avoid disruption to the business.
Goods received	• Only goods ordered by the company are accepted. • Goods received are recorded promptly.
Invoice received	• Invoices received relate to goods actually received. • Invoices received relate to the company. • Invoices received are correct in terms of quantities, prices, discounts.

Recording	• All purchases and related payables are recorded. • Purchases are recorded accurately and related payables are recorded at an appropriate value. • Purchases are recorded in the period to which they relate. • Purchases and payables are recorded in the correct accounts.
Cash payments	• Payments are only made for goods received. • Payments are only made once. • All payments are made on time.

Test your understanding 2

Murray case study: Purchases cycle

Ordering

Goods or services are obtained by placing a purchase requisition with the centralised purchasing department. Requisitions are sequentially pre-numbered and a weekly sequence check is performed. All requisitions must be authorised by an appropriate manager.

On receipt of a purchase requisition, a purchase officer agrees the manager's signature to the signatory list held on file and checks inventory levels where appropriate. Orders are placed with suppliers using sequentially pre-numbered purchase orders.

Orders can only be placed with suppliers from the approved supplier list. Suppliers can only be added to the approved suppliers list by the procurement team once the terms of the contract have been agreed, and references obtained. Written confirmation is requested for all orders placed, and the purchase officer agrees the quoted price against the agreed price list and ensures any bulk discounts to which Murray Co is entitled, have been honoured.

Goods receipt

Goods are received into the central warehouse. Goods are inspected for condition and quantity by a warehouse operative, and agreed to the purchase order before the supplier's delivery note is signed to accept the goods.

A sequentially pre-numbered goods received note (GRN) is prepared by the warehouse team manager, and grid-stamped. The grid stamp is signed by the warehouse operative to confirm that the goods have been inspected for condition and quantity and agreed to the purchase order.

The warehouse manager updates the inventory system on a daily basis from the prepared GRNs. The warehouse manager checks the sequence of purchase orders received on a weekly basis and informs the purchasing department of any missing orders so that they can be followed up.

Invoicing

On receipt of an invoice by the head office accounts team, the invoice is matched to and filed with the relevant GRN, using the purchase order number marked on the invoice (if there is no purchase order number marked on the invoice, this must be obtained from the supplier). The invoice number is noted on the GRN grid stamp. The invoice is also checked to the original purchase order to ensure the agreed prices and discounts have been honoured.

A monthly check of GRNs is made by the purchase ledger manager, to identify any GRNs for which no invoice has been received.

Recording transaction

The purchase ledger clerk enters invoices into the system in batches. A batch control sheet is used, which details the number of invoices and the total value. These details are checked to the system batch report.

Each invoice is stamped as 'recorded' once the details have been entered into the system. The purchase ledger manager inspects the file of invoices on a monthly basis to ensure that all invoices have been recorded.

Suppliers are required to submit monthly supplier statements, which are reconciled to the individual supplier's account by the purchase ledger manager. The list of individual suppliers is reconciled to the trade payables account on a monthly basis by the purchase ledger manager, and reviewed by the company accountant.

Cash payment

The list of payments is sent to the company accountant, who agrees the details of each payment to the relevant invoice and signs each invoice to authorise payment and evidence the check. The list of payments is signed by the accountant once all invoices have been checked, and sent to the cashier's office for payment.

If any individual payment is for more than $25,000 or total payments are for more than $250,000 a second signatory is required. These payments must also be checked and signed by either the financial controller, or finance director.

Payments are made by the cashier's office by bank transfer. Invoices are stamped as 'paid', and returned to the purchase ledger team who record the payment and file the invoices (separately from invoices not yet paid).

The purchase ledger manager checks GRNs on a monthly basis to ensure that invoices have been received and paid on a timely basis.

Required:

In respect of the purchases system for Murray Co:

(i) Identify and explain TEN DIRECT CONTROLS which the auditor may seek to place reliance on; and

(ii) Describe a TEST OF CONTROL the auditor should perform to assess if each of these controls is operating effectively.

Note: Prepare your answer using two columns headed Direct control and Test of control respectively.

(20 marks)

Illustration 2 – Murray Co goods received note

The key document in the purchases cycle is the goods received note:

Murray Co

Goods Received Note: A2012/123478

Purchase Order number: MC/34324832809/RC

Date of receipt: 31st August 20X4

Time of receipt: 12:48pm

Description	**Quantity ordered**	**Quantity received**	**Quality of goods checked**
Vectran	75kg	75kg	Yes

Sign to confirm quantity and quality of goods checked:

Warehouse Operative

Invoice number:

Problems with fraud

Fraud is specifically designed to mislead people. Consider the following example:

- A company only deals with suppliers on a list authorised by the finance director (FD).
- Payments to suppliers are made after the purchases clerk identifies the monthly payments to be made and prepares the cheques.
- The cheques are signed by the FD, who confirms the amounts paid and supplier names to supporting documentation.
- The cheques are countersigned by the managing director, who does not check the details but has a good knowledge of who the suppliers are.
- This appears like a sensible combination of authorisation controls and segregation of duties. The auditor would place reliance on the control system and reduce substantive testing of purchases.

However, now consider the implication if one of the suppliers is actually controlled by the FD. The supplier regularly overcharges the company and the purchases clerk is being bribed by the FD in return for their silence.

It is for this reason that the auditor must always perform some substantive procedures and must always maintain an attitude of professional scepticism.

Non-current assets

Expenditure on non-current assets should be controlled in a similar way to other purchases. However, because of the significant amounts involved, additional controls should be in place.

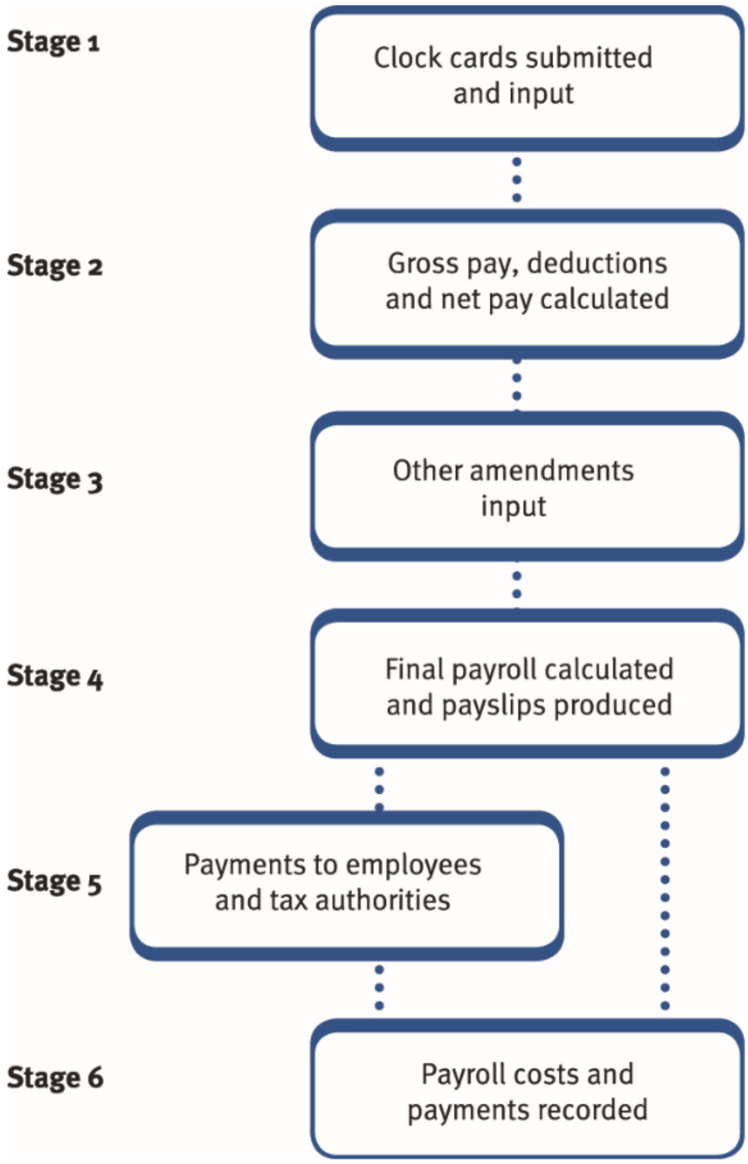
Control objectives

- Assets are only purchased if there is a business need.
- Assets are purchased at an appropriate price.
- The company can afford the asset expenditure proposed.
- Asset expenditure is appropriately treated in the accounting records.
- Asset expenditure is completely and accurately recorded in the accounting records.
- Assets are covered by adequate insurance to prevent loss to the company.
- Documents relating to assets are safeguarded from theft or damage.

Control	Test of control
Requisitions for asset expenditure should be made by an appropriate person.	Inspect the requisition for the signature of the person requisitioning the assets. Ensure this is a person of suitable authority by agreeing the name to a list of people authorised to make such requisitions.
Authorisation for purchases of non-current assets should be at a more senior level.	Inspect the purchase order for signature of appropriate senior person(s).
Several quotations should be obtained before purchase in order to obtain the best price.	Inspect the purchase requisition for the quotations to ensure they have been obtained.

An annual asset expenditure budget for each department should be prepared and authorisation should only be given for purchases which have been budgeted.	Inspect the annual budget to ensure it has been prepared. Inspect board minutes to confirm the budget has been approved by the board. Inspect orders for asset expenditure items to ensure they have been authorised by a responsible official.
Regular review of repairs and maintenance expenditure should be performed to ensure items which should be capitalised have not been expensed in error.	Inspect management accounts/ list of repairs and maintenance expenditure for evidence of review. Enquire of management how discrepancies are dealt with.
A regular reconciliation of the asset register to the physical assets held should be performed.	Inspect the reconciliation of the asset register and evidence of approval by a senior person to ensure the reconciliation has been performed correctly.
An asset register should be maintained which includes cost, depreciation, location, responsible employee, insurance details, etc.	Inspect the asset register to ensure details expected to be recorded have been recorded to ensure good control is maintained over assets.
Adequate insurance cover should be purchased.	Inspect insurance policies to ensure they are in place. Review the policies to ascertain the level of cover in place and compare this with the value of assets to ensure it is sufficient.
Documentation such as title deeds, vehicle registration documents, insurance policies, etc. should be stored in a secure, fire-proof location.	Inspect the storage facilities for important documentation to ensure it is appropriately secure and adequate backups have been maintained in case of a fire or flood.

9 Payroll system



Objectives

The objectives of controls in the payroll system are to ensure that:

Stage	**Objective**
Clock cards (or timesheets) submitted.	• Employees are only paid for work actually done.
Payroll calculation	• Only genuine employees are paid. • Employees are paid at the correct rates of pay. • Gross pay is calculated and recorded accurately. • Net pay is calculated and recorded accurately.
Standing data amendments	• Standing data is kept up to date. • Access to standing data is restricted to prevent fraud or error occurring.
Recording	• All payroll amounts are recorded. • Payroll amounts are recorded accurately. • Payroll costs are recorded in the period to which they relate.
Payments to employees and tax authorities	• Correct amounts are paid to the employees and taxation authorities. • Payments are made on time. • Payments are only made to valid employees.

Test your understanding 3

Murray case study: Payroll cycle

Standing data

The company's HR department is responsible for processing starters and leavers. A copy of the starter's and leaver's forms are sent to the payroll department so the payroll system can be updated.

Non-production staff are paid a salary which increases by the rate of inflation each year. The payroll clerk is responsible for updating the standing data in the payroll system.

The payroll system has the functionality to produce an exception report detailing changes to the payroll standing data but this function is not currently utilised.

Clock cards submitted and input

Production workers are paid according to the number of hours worked. They are required to record their times of arrival and departure at the factory using a clock card which is inserted in a time recording clock. The clocking-in process is not monitored.

On a weekly basis the cards are collected and passed to the works office where the clerk totals up the hours worked on each card and lists the total hours worked (a 'hash' total). The cards and the total hour's list are then passed to the payroll clerk who enters the hours worked into the payroll system and agrees the total entered.

Payroll calculations

The payroll system automatically calculates the gross and net pay along with relevant deductions for both the production and non-production employees. These calculations are not checked. The payroll report is passed to the payroll clerk who creates a payment list detailing the payments to be made to the employees and the taxation authority.

Payments to employees

The majority of employees are paid by bank transfer. The payroll manager reviews the list of bank payments and agrees this to the payroll records. If any discrepancies are noted, the payroll manager always makes the adjustment in the payroll records.

Some employees are paid in cash at the employees' request e.g. if the employee does not have a bank account. Two members of the payroll department produce the pay packets, one is responsible for preparing them and the other checks the finished pay packets. Both members of staff are required to sign the payroll listing on completion of this task. Prepared pay packets are sent to the employee's supervisor, who distributes them to the employee at the end of their shift. Employees do not have to sign anything to confirm they have received their pay packet.

Payroll costs and payments recorded

A copy of the payroll list is sent to the finance department who record the payroll expense and payments made.

Each month, as part of the month-end procedures, a payroll account reconciliation is performed by the financial controller to ensure that the payroll figures have been posted into the accounting records correctly. The reconciliation is not reviewed.

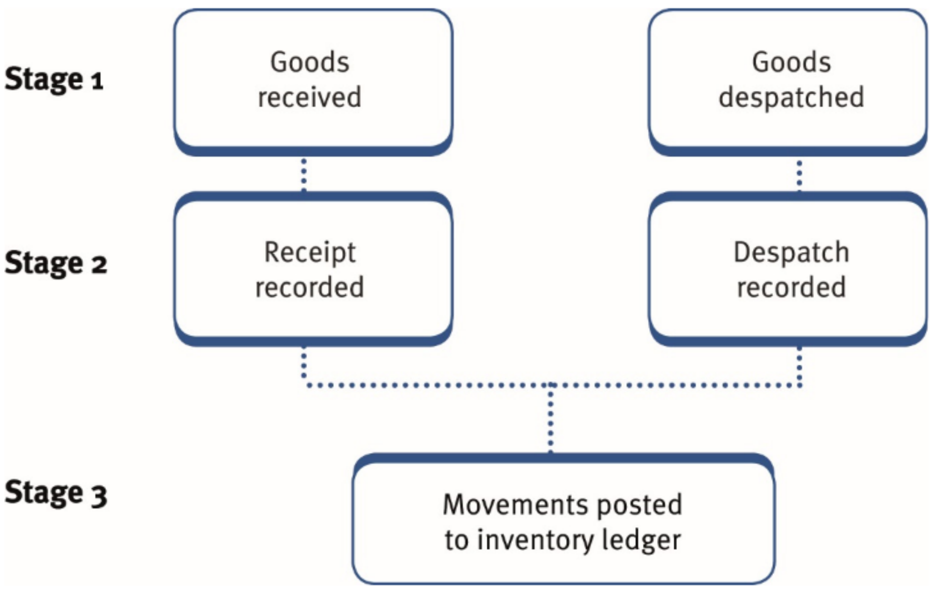
Required:

Identify and explain SIX deficiencies in Murray Co's payroll system and provide a control recommendation to address each of these deficiencies.

Note: Prepare your answer using two columns headed Control deficiency and Recommendation respectively.

(12 marks)

10 Inventory system



Objectives

The objectives of controls in the inventory system are to ensure that:

- Inventory levels meet the needs of production (raw materials and components) and customer demand (finished goods).
- Inventory levels are not excessive, preventing obsolescence and unnecessary storage costs.
- Inventory is safeguarded from theft, loss or damage.
- Inventory received and despatched is recorded on a timely basis.
- All inventory is recorded.
- Inventory should be recorded at the appropriate value.
- Only inventory owned by the company is recorded.

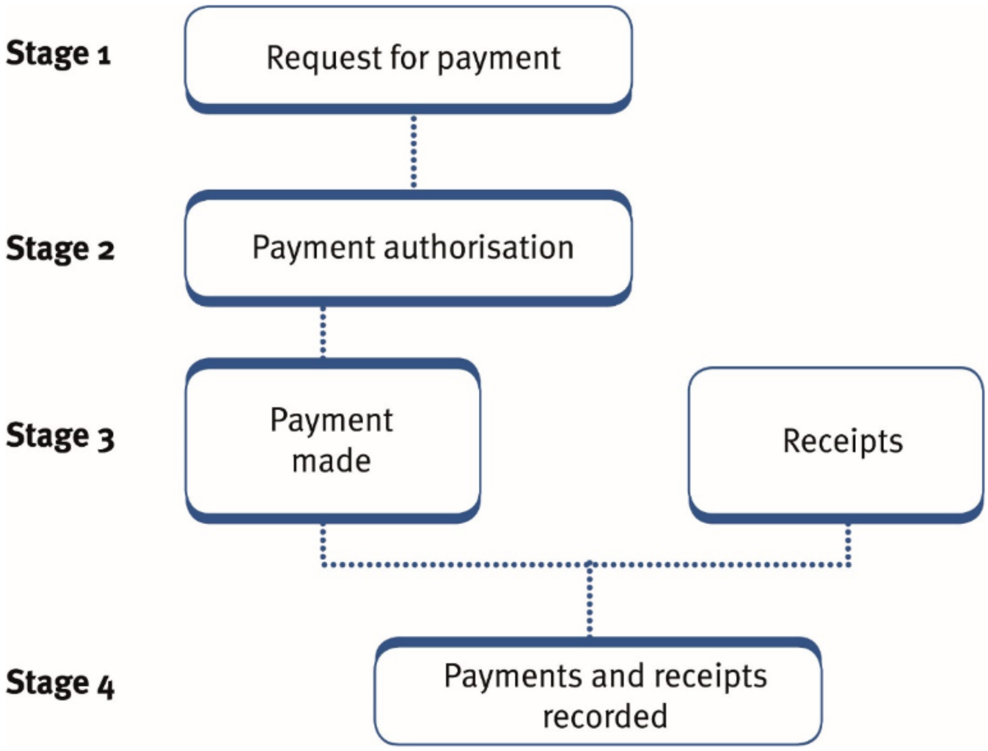
The following controls over inventory relate to the period after purchase and before sale i.e. when the goods are being stored in the warehouse.

Control	Test of control
Inventory should be maintained at an appropriate level through the use of automatic ordering systems when inventory reaches a certain level or by checking inventory levels before orders are placed.	Using test data, place an order which will reduce inventory of an item to below the reorder level and trace through the system to see if an order is automatically generated. Observe the ordering clerk checking inventory levels before placing an order.
Inventory should be kept in a warehouse with access restricted to warehouse staff by the use of swipe card or keypad access. CCTV should be in place to monitor people around the entrance to the warehouse to ensure people do not follow other people into the warehouse without the need for a code/swipe card.	Visit the warehouse and attempt to enter. Ensure that doors are kept closed requiring the swipe card or code to gain access. Inspect the warehouse area to see the CCTV in place and visit the location of the camera feed to ensure the cameras are monitored.
Inventory should be kept in appropriate conditions e.g. temperature-controlled environment for perishable items.	Visit the warehouse and inspect the conditions of storage. Inspect evidence of monitoring the conditions on a regular basis such as temperature logs.

Fire/smoke/heat detectors and sprinkler systems should be in place to reduce the risk of damage caused by fire.	Inspect the warehouse to see the detectors and sprinkler systems are in place. Inspect certificates confirming they have been checked and tested on a regular basis.
Inventory should be insured in case of theft or damage.	Inspect insurance policies to ensure they cover inventory, that adequate cover is in place by comparing against inventory value, and that the policy has not lapsed.
Inventory movements should be recorded in the system promptly using the GRNs and GDNs. The GRNs and GDNs should be stamped to confirm they have been input and the system is up to date.	Inspect the GRNs and GDNs to see they have been stamped as entered into the system. Compare the date on the stamp to the date on the GRN/GDN to ensure they have been entered promptly.
Inventory counts should take place on a regular basis so that physical inventory quantities can be reconciled with the accounting system on a regular basis to ensure the records are accurate and up to date.	Obtain inventory counting instructions and review to ensure the count will be appropriately organised and controlled. Attend the inventory count to ensure the count is carried out in accordance with the instructions and perform test counts to ensure the client's counts are carried out accurately.
Inventory should be reviewed during the count for damage or obsolescence and valued separately from the other inventory by making an allowance to write the inventory down to net realisable value.	During the count, review the inventory to ensure damaged or obsolete items are separately identified.

See the 'Procedures' chapter for detailed controls over inventory counts.

11 Bank and cash system



Objectives

The objectives of controls in the cash cycle are to ensure that:

- Petty cash levels are kept to a minimum, preventing theft.
- Payments can only be made for legitimate business expenditure.
- Cash can only be withdrawn for business purposes.
- Cash is safeguarded to prevent theft.
- Receipts are banked on a timely basis to prevent theft.
- Cash movements are recorded on a timely basis.

The following controls over cash relate to the period after receipt from a customer and before being used to pay for expenses. In addition, there should be adequate controls over access to cash and bank records.

Control	Test of control
An imprest system of petty cash should be used for items of expenditure less than $x. All other reimbursements should be made through an expense claim and processed as a bank payment.	In the presence of the client, count the petty cash to ascertain that the level is at the limit set. Inspect the petty cash vouchers to ensure amounts reimbursed are below the limit stated.

Petty cash reimbursements must be supported by an invoice to confirm the expenditure was incurred and is business related before being authorised and paid.	Inspect the petty cash reimbursements for the supporting invoice and the signature of the person authorising the reimbursement.
Cash withdrawals must be authorised by a manager.	Inspect the withdrawal request for evidence of the manager's signature authorising that the money can be taken out of the bank.
Cash and cheque books should be stored in a locked safe with restricted access.	In the presence of the client, inspect where the cash and cheque books are stored to ensure they are secure, e.g. within a safe. Enquire of management who has access to the safe to ensure this is restricted to people with suitable seniority.
Controls over bank transfers and online banking should be in place, e.g. secure passwords and PINs.	Enquire of management who has access to the online banking system. Inspect transactions in the banking system for the username of the person initiating and authorising transactions to ensure this corroborates what has been said. Assess whether the person authorising the transactions is of suitable seniority.
Cash and cheques received should be banked frequently.	Inspect the paying in books or bank statements to identify how frequently deposits are paid in to ensure this is adequate.
Bank reconciliations should be prepared on a regular basis (e.g. weekly) and reviewed by a responsible official to confirm it has been reconciled properly.	Inspect the file of bank reconciliations to ensure they are performed regularly. Inspect the reconciliation for a manager's signature as evidence it has been reviewed and approved. Reperform the reconciliation to ensure it has been carried out effectively.

Exam question approach

The exam is likely to include one, or both, of the following requirements:

- Identify and explain the **control deficiencies** from the scenario and provide **recommendations** to overcome the deficiencies.
- Identify and explain the **direct controls** from the scenario and describe **tests of controls** the auditor would perform to obtain evidence that the control is working effectively.

Control deficiencies

Identification of the deficiencies is usually quite straightforward. You should look for information which indicates:

- Controls are missing e.g. Sales orders are not sequentially numbered.
- Controls are not effective e.g. Bank reconciliations are supposed to be performed but often don't get done due to lack of time.

Work with the information provided. Do not assume that because something isn't mentioned it isn't happening.

Explanation of the deficiency requires you to explain the implication for the company or a risk of misstatement in the accounting records. It is not an explanation if you only say this should not be done or this should be done. You must explain what the control would achieve if it was in place and working effectively. The explanation needs to be sufficiently detailed. If you only explain the deficiency in part you will not earn the explanation marks.

Recommendation

For the recommendation, suggest the control procedure which needs to be implemented. This also needs to be sufficiently detailed. Try and recommend which person within the company should perform the control and how frequently. Sometimes a control requires more than one element to be effective, therefore make sure you suggest everything that needs to happen to make the control effective.

	Control deficiency	**Recommendation**
Poor answer	Sales orders are not sequentially numbered. *Deficiency is not explained. Why does it matter if the sales orders are not sequentially numbered?*	Orders should be sequentially numbered. *Recommendation is not sufficiently detailed. How does the client know the sequence is complete?*
Better answer	Sales orders are not sequentially numbered. Orders will be difficult to trace and orders may not be fulfilled. *Deficiency is still not fully explained.* *What are the consequences to the company if it has unfulfilled orders?*	Orders should be sequentially numbered. A sequence check should be performed and any breaks in the sequence investigated and resolved. *Recommendation is now sufficiently detailed.*
Good answer	Sales orders are not sequentially numbered. Sales orders may not be completely recorded resulting in unfulfilled orders. Orders received but not recorded will be difficult to trace. Customers will be dissatisfied if orders are not fulfilled resulting in complaints and loss of future revenue.	Orders should be sequentially numbered. A sequence check should be performed and any breaks in the sequence investigated and resolved.

	Control deficiency	Recommendation
Poor answer	Bank reconciliations are supposed to be performed but often don't get done due to lack of time. *Deficiency is not explained. Why does it matter if the bank reconciliation does not get performed?*	Bank reconciliations should be performed. *Recommendation is not sufficiently detailed. Who should perform the bank reconciliation?* *How often should it be performed?* *How does management know it has actually been done?*
Better answer	Bank reconciliations are supposed to be performed but often don't get done due to lack of time. Errors could occur. *Deficiency is still not fully explained.* *Errors in what?*	Bank reconciliations should be performed weekly. *Recommendation is slightly better but is still not sufficiently detailed.*
Good answer	Bank reconciliations are supposed to be performed but often don't get done due to lack of time. Errors could occur. The bank ledger account may be incorrect resulting in misstatement of the bank and cash figure in the financial statements.	Bank reconciliations should be performed on a weekly basis by someone independent of maintaining the bank ledger account and the reconciliation should be reviewed by a responsible official.

Direct controls

Direct controls are control procedures which are properly designed, in place and working effectively at addressing the risk of material misstatement at the assertion level.

Read the scenario and look for mention of controls such as reconciliations being performed, authorisation of transactions, segregation of duties, restricted access to valuable items, etc.

A control is an activity that is performed **in addition** to the normal processing of the system, to ensure that the system has operated as it should. For example, raising a sales invoice is part of a normal sales system, it is not a control. A control would be someone performing a check to confirm the sales invoice had been raised accurately, or someone performing a check to confirm completeness of sales invoices in relation to GDNs. A control to confirm accuracy of invoices might be a sales manager agreeing the price on the invoice to the company's authorised price list and recalculating the invoices to confirm accuracy before they are sent to the customer. A control to confirm completeness of sales invoices might be that sales invoices are matched to GDNs and every week a sales manager performs a review of sales invoices to identify any unmatched invoices which are then investigated.

Make sure that there is nothing mentioned which would make the control ineffective. For example, duties may be segregated between two individuals who are related. This increases the risk of collusion which negates the control. Reconciliations might be performed infrequently and not reviewed by anyone. Therefore, the control is ineffective as it is not being performed all of the time, and no-one is checking that it has been performed correctly.

Tests of controls

A test of control is an audit procedure which will provide evidence as to whether the control procedure is in place and working effectively.

The focus of a test of control is the control procedure. If a direct control identified is segregation of duties between calculating payroll and making the payroll payment, the auditor will need to obtain evidence that these duties are segregated e.g. by observing the procedures and inspecting procedures documents and organisation charts to ensure different people are responsible for each task.

Tests of controls are not substantive procedures. Therefore, when testing the control, the auditor does not need to test the balance which will go into the financial statements.

	Direct control	**Test of control**
Poor answer	GDNs are matched to sales invoices. *There is no explanation of the control objective.*	Agree the amount recorded on the sales invoice and GDN to the detailed sales listing. *This is a substantive procedure, not a test of control. The objective of a test of control is to confirm the control is in place, i.e. that the GDNs are matched to the sales invoices.*
Better answer	GDNs are matched to sales invoices. This reduces the risk of errors. *The control explanation is too vague. Reduces the risk of errors in what?*	Inspect the GDNs and sales invoices. *The test of control does not explain the objective of the test. What are we inspecting the GDNs and invoices for?*
Good answer	GDNs are matched to sales invoices by a finance clerk and signed to confirm the matching has been performed. This ensures the customer is invoiced for the correct goods which will reduce the risk of disputes and ensure sales are recorded accurately.	Inspect a sample of GDNs and related invoices to confirm the details match and inspect for evidence of the finance clerk's signature confirming the matching has been performed.

Test your understanding 4

Rhapsody Co supplies a wide range of garden and agricultural products to trade and domestic customers. The company has 11 divisions, with each division specialising in the sale of specific products, for example, seeds, garden furniture, and agricultural fertilizers. The company has an internal audit department which provides reports to the audit committee on each division on a rotational basis.

Products in the seed division are offered for sale to domestic customers via an Internet site. Customers review the product list on the Internet and place orders for packets of seeds using specific product codes, along with their credit card details, onto Rhapsody Co's secure server. Order quantities are normally between one and three packets for each type of seed. Order details are transferred manually into the company's internal inventory control and sales system and a two-part packing list is printed in the seed warehouse. Each order and packing list is given a random alphabetical code based on the name of the employee inputting the order, the date and the products being ordered.

In the seed warehouse, the packets of seeds for each order are taken from specific bins and despatched to the customer with one copy of the packing list. The second copy of the packing list is sent to the accounts department where the inventory and sales computer is updated to show that the order has been despatched. The customer's credit card is then charged by the inventory control and sales computer. Irrecoverable receivables in Rhapsody Co are currently 3% of the total sales.

The computer system checks that for each charge made to a customer's credit card account, the order details are on file to prove that the charge was made correctly.

Required:

In respect of sales in the seeds division of Rhapsody Co:

(i) Explain FOUR deficiencies in the sales system, and

(ii) For each deficiency provide a recommendation to overcome that deficiency.

Note: Prepare your answer using two columns headed Control deficiency and Control recommendation respectively.

(8 marks)

Test your understanding 5

Whilst performing tests of controls, many control deviations were found. The auditor has therefore concluded that reliance cannot be placed on the internal controls.

Required:

Explain THREE actions that the auditor may now take in response to this problem.

(3 marks)

Test your understanding 6

(a) **Define 'tests of control' and explain the importance of tests of control in the audit of a company.**

(2 marks)

(b) You are an audit senior working at a medium sized firm of auditors. One of your clients, Numero Uno, is an exclusive hotel situated in the centre of Big City. As part of your audit procedures, you are assessing the controls surrounding payroll. You have read last year's audit file and have obtained the following information:

The hotel employs both full and part time staff. Due to the nature of the business most of the work is done in shifts. All staff are paid on a monthly basis.

New members of staff are given an electronic photo identification card on the day they join by the personnel department. This card is used to 'clock in' and 'clock out' at the start and end of the shift to record the hours worked.

At the end of each week the information recorded on the system is sent automatically to the payroll department and also to the head of each of the three main operating divisions: Rooms, Food & Beverage and Corporate Events. Each head of division must reply to the payroll department by email to authorise the hours worked by their staff.

The payroll clerk collates all the authorised information and inputs the hours worked into a standardised computerised payroll package. This system is password protected using an alphanumerical password that is only known to the payroll clerk and the finance manager.

Once the hours have been entered, the calculations of gross pay and taxation are calculated automatically along with any other statutory deductions. Once calculated, a payroll report is produced and printed. The finance manager reviews the report and compares the data to last month to identify and follow up any unusual variances. Once satisfied with the information, the finance manager authorises the payroll run by signing the payroll report and the payroll clerk submits the data.

Payslips are sent to the home address of each employee and payment is made by bank transfer.

Required:

In respect of the payroll system for Numero Uno:

(i) Identify and explain FOUR DIRECT CONTROLS which the auditor may seek to place reliance on; and

(ii) Describe a TEST OF CONTROL the auditor should perform to assess if each of these controls is operating effectively.

Note: Prepare your answer using two columns headed Direct control and Test of control respectively.

(8 marks)

(Total: 10 marks)

Test your understanding 7

You are testing the controls over the payroll system of Bunbury Co. You have confirmed that the following controls have operated throughout the year:

- Sample check of payroll calculations by a payroll manager.
- Review of the payroll listing once prepared before details are entered into the banking system.
- Segregation of duties between calculation of monthly payroll and responsibility for changes to standing data.
- Each department manager receives a list of employees in their department for them to sign to confirm those employees should be paid.

1 **Which of the following is the main reason for the control of segregation of duties between calculation of payroll and responsibility for changes to standing data?**

A Changes to standing data must be performed by a manager whereas payroll calculations can be performed by a payroll clerk

B If one person was responsible for both they would be more likely to make errors due to a high workload

C If one person was responsible for both they could increase their salary and make fraudulent payments to themselves

D Each individual role within an organisation must be carried out by different people

2 **Which of the following procedures would provide the most reliable evidence that the first control, payroll calculations are checked by a payroll manager, is working effectively?**

A Enquiry with the payroll clerk performing the payroll calculation

B Enquiry with the payroll manager performing the check

C Recalculation of the payroll amounts by the auditor

D Inspection of the payroll report for evidence that a sample of payroll amounts are checked

3 **Which of the following is NOT a test of control?**

A Inspection of employee contracts to confirm the salary the employee should be paid

B Inspection of payroll reports for evidence of authorisation by the manager

C Inspection of the list of employees for each department for evidence of the department manager's review

D Observation of the payroll function to confirm segregation of duties is in place

4 **Which of the following is a control objective relevant to the control that each department manager reviews the list of employees?**

A To ensure payroll is accurately calculated

B To ensure only valid employees are paid

C To ensure employees are paid for the correct hours

D To ensure employees are paid at the correct salary

5 **Which of the following could be used by Bunbury Co to monitor the effectiveness of the company's controls?**

A Internal audit assignments

B Performing bank reconciliations

C Authorisation of payments

D Segregation of duties

Test your understanding 8

You are performing the risk assessment for the audit of Kununurra Co, a client your firm has audited for the past two years. From your review of last year's audit file you have found that no significant control deficiencies were identified. The systems are documented on the permanent audit file in the form of flow charts and narrative notes.

1 **Which of the following best describes the requirement of the auditor in respect of the controls documentation?**

A The auditor must document the systems this year as they may have changed since last year

B The auditor may enquire whether the systems have changed since last year, and if not, no further work is necessary

C The auditor must perform procedures to ensure the systems work as documented on file e.g. by performing walkthrough tests

D No work is necessary on systems documentation unless the client informs the auditor that changes have occurred

2 **Which of the following best describes the auditor's approach in respect of reliance on internal controls?**

A Tests of controls must be performed over material areas of the financial statements

B Tests of controls must be performed each year over areas of significant risk where the auditor is hoping to place reliance on controls

C Tests of controls are not necessary this year as no deficiencies were identified last year

D Tests of controls must be performed over all areas irrespective of whether the auditor is planning to place reliance on those controls

3 **Which of the following questions would NOT be included in an internal control evaluation questionnaire?**

A How does the company ensure sales are only made to creditworthy customers?

B How does the company ensure that purchases are only made for a valid business use?

C How does the company ensure that all purchases are recorded?

D Is access to the warehouse restricted to authorised personnel only?

4 **Internal controls should be monitored on an ongoing basis to ensure they are adequate, relevant and working effectively. Which of the following will NOT monitor the internal controls of a company?**

A External auditor

B Management

C Consultancy firm hired by management

D Internal auditor

5 **Match the description to the appropriate method of documenting a control system.**

A diagram depicting the controls in place at each stage of a process	**ICQ/ICE**	**Flowchart**	**Narrative notes**
A disadvantage of this method may be that controls are overstated	**ICQ/ICE**	**Flowchart**	**Narrative notes**
An advantage of this method is that they are easy to prepare in advance and therefore efficient	**ICQ/ICE**	**Flowchart**	**Narrative notes**
For larger systems this method may be time consuming and it may be difficult to identify missing controls	**ICQ/ICE**	**Flowchart**	**Narrative notes**

12 Chapter summary

SYSTEMS AND CONTROLS
- Revenue
- Purchases
- Payroll
- Inventory
- Cash and bank
- Non-current assets

UNDERSTAND THE COMPONENTS OF THE CONTROL SYSTEM
- Control environment
- Risk assessment process
- Information systems
- Control activities
- Monitoring

CONTROL ACTIVITIES
- Authorisation
- Reconciliations
- Verifications
- Physical or logical controls
- Segregation of duties

DOCUMENT THE SYSTEMS
- Narrative notes
- Flowcharts
- ICQs
- Organisation charts

TEST THE SYSTEMS
- Tests of controls
- Test data

COMMUNICATE DEFICIENCIES
- All deficiencies to management
- Significant deficiencies to TCWG

Test your understanding answers

Test your understanding 1

(a) **Direct controls and tests of control**

Direct control	**Test of control**
Credit checks are performed and credit limits set: sales are only made to customers that are likely to make a full and prompt payment, reducing the risk of irrecoverable debts. Irrecoverable debts will reduce profit and cash inflows and if not written off will result in overstatement of receivables.	Inspect a sample of customer files to ensure a credit check has been performed. Inspect the customer's account within the system to ensure credit limits have been put in place.
A second member of the warehouse team checks the goods packed, signing the GDN to evidence the check: segregation of duties. Segregation of duties reduces the risk of theft and fraud which results in loss for the company and potential misstatements in the accounting records.	Visit a warehouse and observe the goods despatch process to assess whether all goods are double checked against the GDN prior to signing and sending out. Inspect the GDN for evidence of the signature to confirm the physical goods have been checked to the GDN and the GDN has been checked against the order prior to despatch.
Customers sign the GDN and return it to Murray Co: this helps to minimise disputes as proof of delivery and acceptance of goods is obtained. Disputes with customers may result in overstatement of receivables and also a loss of customer goodwill.	Inspect a sample of GDNs retained by the warehouse to ensure they are signed by customers to confirm receipt of goods and to confirm they are retained in the warehouse in case of disputes.

The invoice is raised from the GDN: this ensures the invoice relates to the actual quantity of goods despatched rather than the order which may be different. This reduces the risk of customers being invoiced incorrectly which would result in misstatement of revenue and receivables. This could also cause customer dissatisfaction and a loss of customer goodwill.	Inspect the GDNs for evidence of being matched to invoices. Agree the details on both to ensure the control has been effective.
Sales invoices are prepared using the company price list: this ensures customers are invoiced correctly. Incorrect invoicing will result in misstatement of revenue and receivables. This could also cause customer dissatisfaction and a loss of customer goodwill.	Inspect the price list for approval by the directors. Obtain a copy of the current price list and, for a sample of invoices, agree that the correct prices have been used. Agree the prices in the system to the approved price list. Enquire of management who has authority to amend standing data such as prices in the system to ensure only persons of suitable authority have access. Try to input a change to the prices in the system using a user ID of a clerk to ensure that the system does not allow access to this standing data.
Discounts must be requested by a sales manager and authorised by the sales director: segregation of duties and authorisation. This reduces the risk of fraud and unauthorised discounts which will result in loss of revenue for the company and possible misstatement within the accounting records.	With the client's permission, attempt to process an invoice with a sales discount not authorised by the sales director. The system should reject the invoice. Inspect sales orders with discounts given for evidence of the sales director's signature authorising the discount.

Review of the list of individual customers for credit balances: identifies possible overpayments or errors within the trade receivables account. Errors in the accounting records can be promptly corrected.	Inspect the list of individual customers for evidence of monthly review for credit balances such as a manager's signature.
Monthly customer statements sent to customers: reminds customers of the invoices they need to pay and enables them to identify errors in invoices which can be notified to Murray Co. This can reduce the risk of irrecoverable debts. Irrecoverable debts will reduce profit and cash inflows and if not written off will result in overstatement of receivables.	For a sample of customers, inspect copies of monthly statements sent out to confirm statements are in fact issued.
Receipts are counted by the office assistant, recorded by the cashier, and the sales ledger clerk agrees the amount received to the amount invoiced: segregation of duties. Segregation of duties reduces the risk of fraud which could cause misstatement in the accounting records and loss for the company.	Observe the cash receipt process to assess the adequacy of segregation of duties.

(b) **Control deficiencies and recommendations**

Control deficiency	**Recommendation**
Credit checks are only reperformed if a customer requests an increase to their credit limit. A customer's credit rating may have deteriorated but Murray Co will not know and continue to give the same level of credit which increases the risk of irrecoverable debts, affecting profit and cash flow. Irrecoverable debts may result in possible overstatement of receivables.	Credit checks should be performed annually to ensure the credit limit originally given to the customer is still appropriate. If the credit status has changed, the credit limit should be revised.

Credit limits are checked after the order has been accepted. The customer may not have sufficient credit which may result in irrecoverable debts and a reduction to profit. Irrecoverable debts may result in overstatement of receivables.	Credit limits should be checked before the order is confirmed to ensure the customer has sufficient credit.
Sales invoices are not sequentially numbered. Goods may not have been invoiced which will result in lost revenue and profit for the company. The company will not be able to identify if any invoices are missing resulting in understatement of revenue.	Sales invoices should be sequentially numbered and a sequence check should be performed by the accounts department on a daily/weekly basis. Any breaks in the sequence should be investigated.
No review is performed to ensure all goods have been invoiced. Goods may not have been invoiced which will result in understatement of revenue.	A review should be performed to ensure that every GDN has a matching invoice to ensure all goods have been invoiced.
The list of individual customer balances is only reconciled when the sales manager has time. Errors may exist within the receivables accounting records which will not be identified and resolved on a timely basis.	The list of individual customer balances should be reconciled to the trade receivables account on a monthly basis. The reconciliations should be reviewed by a different, responsible official to ensure the reconciliation has been performed properly.
The credit controller only follows up on balances which are six-months overdue. This increases the risk of irrecoverable debts which will reduce profit and cash inflows. Irrecoverable debts may result in overstatement of receivables.	Credit control procedures should be followed to ensure full and prompt payment by customers, e.g. a telephone call to the customer followed by a letter.

Test your understanding 2

Ordering

Control	Test of control
Centralised purchasing department: ensures that purchasing is cost effective and only necessary goods and services are procured, reducing the risk of loss to the company and unnecessary cash outflow. Over-ordering of goods could lead to a build-up of inventory levels which could result in overstatement of inventory.	Inspect the organisation chart to verify that a centralised purchasing department is in place. Enquire of the purchasing director whether all purchases must go through the department, or if some purchases are made within individual departments, to assess the effectiveness of the control. Inspect a sample of purchase orders to ensure they have been generated by the central purchasing department.
Requisitions are authorised and manager's signature agreed: ensures only necessary goods and services are procured, reducing the risk unnecessary cash outflow. Unnecessary goods could lead to a build-up of inventory levels which could result in overstatement of inventory. Unauthorised purchases could be fraudulent which would result in expenses not pertaining to the company (occurrence assertion).	Inspect a sample of requisitions for the signature of an appropriate manager.
Inventory levels are checked prior to ordering: ensures only necessary goods and services are procured, reducing the risk of inventory becoming obsolete which could lead to overstatement of inventory and loss for the company.	Inspect a sample of requisitions for evidence of inventory levels being checked first, such as a signature. Observe the ordering process to see the ordering clerk checking inventory levels first.

Sequentially pre-numbered purchase orders and a weekly check by warehouse manager: ensures that all goods and services ordered are received so any missing purchase orders can be followed up. This reduces the risk of production delays which will result in dissatisfied customers and a loss of customer goodwill. Missing purchase orders will result in an incomplete audit trail and may affect the auditor's ability to obtain sufficient and appropriate evidence over purchases.	Review the purchase orders for evidence of the warehouse manager's weekly sequence check such as a signature to confirm it has been performed.
Approved supplier list: gives assurance about the quality of goods and services and reliability of the suppliers. Poor-quality supplies will affect the quality of the product sold resulting in complaints from customers and damage to the company's reputation reducing future sales. If product quality is affected, there is a risk of overstatement of inventory and understatement of refund liabilities.	For a sample of purchase orders placed, agree the supplier name to the approved supplier list. Attempt to place an order with an unapproved supplier. The system should not allow it to proceed.
Prices are agreed to the price list and discounts checked: ensures that the correct prices are being charged by the supplier and discounts are being obtained. This ensures accuracy of purchases and payables and reduces the risk of loss to the company and unnecessary cash outflow.	Inspect a sample of purchase orders for evidence of prices having been agreed to the price list such as a signature of the person checking. Select a sample of orders and agree to the authorised price list to test the effectiveness of the control.

Goods receipt

Control	**Test of control**
Goods received into the central warehouse. Having one, secure delivery area prevents goods received being lost or stolen reducing the risk of loss to the company and misstatement of the inventory balance.	Visit a warehouse and inspect the delivery area for security of goods e.g. locked area, security guard, CCTV.
Goods are inspected for condition and quantity and agreed to the purchase order. This prevents Murray Co from paying for unnecessary, or poor-quality goods which would result in loss for the company and unnecessary cash outflow. Damaged goods received and not returned to the supplier may result in overstatement of inventory.	Observe the goods receipt process to ensure goods are inspected for condition and quantity before the supplier's delivery note is signed. Inspect the delivery note for a signature confirming the goods have been checked on arrival.
Sequentially pre-numbered goods received note (GRN) prepared by the warehouse team manager and a sequence check performed by the purchase ledger manager. This ensures that all goods received are recorded which will ensure completeness of inventory balances.	Inspect evidence of the sequence check being performed such as a signature of the warehouse manager.
Grid stamp: a grid stamp is a grid that can be ink-stamped onto any document, with boxes for recording different information such as confirmation the goods have been inspected for condition and agreed to the purchase order. This prevents Murray Co from paying for unnecessary or poor-quality goods reducing the risk of loss to the company and unnecessary cash outflow. This reduces the risk of inappropriate valuation of inventory.	Inspect a sample of GRNs to ensure they are grid-stamped and signed by the warehouse operative to confirm the goods have been inspected and agreed to the PO.

Inventory system updated on a daily basis by the warehouse manager: prevents unnecessary goods being ordered and ensures accuracy of inventory balances. This reduces the risk of not being able to fulfil customer orders which could result in dissatisfied customers and a loss of customer goodwill.	Inspect a sample of GRNs for the previous day to ensure the inventory system has been updated for them.

Invoicing

Control	**Test of control**
The invoice is matched to the GRN: by matching the invoice to the GRN and not the original order it ensures that only goods that have been received are paid for, reducing the risk of loss to the company and unnecessary cash outflow and ensuring accuracy of purchases and payables.	Inspect a sample of invoices and ensure they are filed with the relevant GRN, and the invoice number is written on the GRN.
Using the purchase order number marked on the invoice: when placing an order, the supplier will be given the purchase order number. This allows the purchase to be matched to the relevant GRN and requisition and the company can efficiently trace the relevant documentation in case of queries.	Inspect a sample of invoices for the PO number and that it is matched to the relating GRN and requisition.
The invoice number is noted on the GRN grid stamp, and a monthly check of GRNs with no invoice: this prevents goods received being invoiced twice which would cause loss to the company and overstatement of purchases and payables.	Review the GRN for the grid stamp. Inspect evidence of signature to confirm the monthly check has been carried out by the purchase ledger manager.

Recording transaction

Control	Test of control
Batch controls: the system will notify the clerk inputting the data of how many invoices have been input. This will be checked to the physical number of invoices and will highlight if too many or too few invoices have been entered. This ensures accuracy of the purchases and payables figures in the accounting records enabling invoices to be paid on time reducing the risk of disputes with suppliers.	Inspect a sample of batch control sheets for evidence of completion and agreement to the batch system report.
Invoice stamped as 'recorded' and checks to ensure all invoices recorded: Prevents under or overstatement of trade payables reducing the risk of disputes with or late payments to suppliers.	Select a sample of invoices recorded on the system and inspect them to ensure they are marked as 'recorded'.
Supplier statement reconciliations: enables errors in the recording of purchases, payments and liabilities to be identified and corrected. This reduces the risk of disputes with suppliers and ensures accuracy of the accounting system relating to purchases and payables.	For a sample of suppliers, inspect the monthly supplier statements received for evidence of the reconciliation being performed. Reperform the reconciliation to confirm it has been reconciled correctly to test the effectiveness of the control.
Trade payables account reconciliation: ensures that credits and payments recorded in individual supplier accounts have also been recorded in the accounts (and vice versa). Segregation of duties monitors performance of controls and ensures accuracy of the accounting system in relation to purchases and payables.	Inspect the account reconciliations for evidence of performance and review on a monthly basis. Reperform the reconciliation to ensure it has been carried out effectively.

Cash payment

Control	Test of control
The company accountant checks and authorises payments: payments should only be authorised by a senior member of the finance department to prevent error or fraud which could result in loss for the company and misstatements in the accounting records.	For a sample of payments made, inspect the payment list for evidence of the company accountant's review and authorisation.
Individual payments of more than \$25,000 or total payments of more than \$250,000 require a second signatory: a second signatory prevents fraud on unusual transactions which could result in loss for the company and misstatements in the accounting records. The additional check by the financial controller or finance director further enhances this control.	Inspect a sample of invoices > \$25,000 for evidence of a second signatory and agree that the signature is of someone with authority to authorise such amounts. Inspect the invoices for the additional signature of the financial controller or finance director.
Payments are made by the cashier's office and recorded by the purchase ledger team: segregation of duties prevents fraud which could result in loss for the company and misstatements in the accounting records.	Observe the process of payments from the cashier's office to ensure segregation of duties is in place.
Invoices are stamped as ‘paid’ and filed separately from invoices not yet paid: this prevents invoices being paid twice which could result in loss for the company and unnecessary cash outflow and would result in misstatement of payables and purchases.	Inspect the file of paid invoices and ensure they are kept separate from invoices not yet paid. Inspect them stamped as 'Paid'.

Test your understanding 3

Standing data

Control deficiency	Recommendation
Standing data is updated by the payroll clerk. The payroll clerk is not sufficiently senior to be making changes to standing data. Mistakes or unauthorised changes could be made, causing loss for the company or employee dissatisfaction.	Amendments to standing data should be performed by a senior member of the payroll department and this should be checked by another responsible official.
Exception reporting functionality is currently not utilised by Murray Co. Unauthorised changes or incorrect amendments to payroll will not be identified on a timely basis, which could cause loss for the company.	An exception report should be produced on a regular basis e.g. monthly. The report should be reviewed by a responsible official such as the payroll director. Any unexpected amendments should be investigated.

Clock cards submitted and input

The clocking in process is not supervised. This could result in a number of employees being clocked in as present when they are not. This will result in increased payroll cost for Murray Co.	The clocking in and out process should be monitored by installing CCTV over the clocking in/out area or introducing a video access system to identify individuals as they enter the building. Alternatively, a responsible official should oversee the process to prevent one individual clocking in multiple employees.
The hours worked entered into the payroll system by the payroll clerk is not checked. Mistakes or unauthorised changes could be made, causing loss for the company or employee dissatisfaction.	Hours worked entered into the system by the payroll clerk should be checked by the payroll manager before the payroll system calculates the gross and net pay, and deductions.

Payroll calculations

The payroll system automatically calculates the gross pay, net pay and deductions but there are no checks performed. Errors occurring within the system would not be identified. This could result in payroll being over or under calculated, leading to an additional payroll cost or loss of employee goodwill.	A senior member of the payroll team should recalculate the gross to net pay workings for a sample of employees and compare their results to the output from the payroll system. These calculations should be signed as checked and confirmed before payments are made.

Payments to employees

Tutorial note

The payment of wages in cash is not a deficiency in itself.

The payroll manager reviews the bank transfer listing prior to authorising the payments and if any discrepancies are noted, always makes the adjustment in the payroll records for any changes required. There is a lack of segregation of duties. The manager could fraudulently increase or incorrectly amend the amounts to be paid to certain employees, process this payment as well as amend the records. This will cause loss for the company.	The payroll manager should not be able to process changes to the payroll system as well as authorise payments. Discrepancies should be thoroughly investigated, and adjustments made in the relevant record as required. The authorisation of the bank transfer listing should be undertaken by an individual outside the payroll department, such as the finance director.
Prepared pay packets are sent to the employee's supervisor, who distributes them to employee at the end of their shift. The supervisor is not sufficiently independent to pay wages out. They could adjust pay packets to increase those of close friends whilst reducing others. This will cause loss for the company.	Employees paid in cash should collect their pay packets from the payroll department or cashier's office.

In addition, employees do not have to sign anything to say they have received their wages. This could result in employees claiming that they have not been paid when they have and payments being made twice which will increase cost for the company.	Employees paid in cash must sign a collection receipt to confirm they have received their wages and that they have been paid the correct amount.

Payroll costs and payments recorded

A payroll account reconciliation is performed by the financial controller but is not reviewed. The reconciliation could reconcile but contain significant compensating errors which cancel each other out. If it is not reviewed, then this reduces its effectiveness and fraudulent payroll expenses will not be identified. This will cause loss for the company.	The payroll account reconciliations should be reviewed by the finance director once prepared, even if there are no exceptions. There should evidence of the review by way of a signature on the reconciliation.

Test your understanding 4

Deficiency and effect	**Recommendation**
Recording of orders	
Orders placed on the website are transferred manually into the inventory and sales system. Manual transfer may result in errors in the accounting system. Customers will be sent incorrect goods resulting in increased customer complaints and a loss of customer goodwill.	The computer system should be upgraded so that order details are transferred directly between the two computer systems. This will remove manual transfer of details, limiting the possibility of human error.

Control over orders and packing lists	
Each order/packing list is given a random alphabetical code. This type of code makes it difficult to check completeness of orders. Packing lists can be lost resulting in goods not being despatched to the customer which will result in a loss of customer goodwill. The order may be sent but the customer's credit card may not be charged which would result in understatement of revenue.	Orders/packing lists should be controlled with a numeric sequence. At the end of each day, a sequence check should be performed and any gaps in the sequence should be investigated.
Obtaining payment	
The customer's credit card is charged after despatch of goods to the customer, meaning that goods are already sent to the customer before payment is authorised. Rhapsody Co will not be paid for the goods despatched where the credit company rejects the payment request. Given that customers are unlikely to return seeds, Rhapsody Co will automatically incur an irrecoverable debt which reduces profit and cash inflow and leads to a potential overstatement of receivables.	Authorisation to charge the customer's credit card should be obtained prior to despatch of goods and the card should be charged on despatch to ensure Rhapsody Co is paid for all goods sent to customers.
Completeness of orders	
There is no overall check that all orders recorded on the inventory and sales system have actually been invoiced and the customer's credit card charged. Orders despatched may not have been invoiced resulting in understatement of revenue and profit. If the credit card has not been charged the company will experience a reduction in cash flow.	An exception report of orders not invoiced should be generated each week. Orders where there is no corresponding invoice should be investigated.

Test your understanding 5

The auditor can increase the amount of controls testing in that audit area. This may indicate that the control deficiency was not as bad as initially thought.

The problem can be raised with management and those charged with governance so that corrective action can be taken.

The auditor can perform additional substantive procedures on the audit area. If controls have not worked effectively there is a greater risk of misstatement. Substantive procedures will be used to quantify the misstatement.

If the matter is not resolved, then the auditor will also need to consider the implications for the auditor's report.

Test your understanding 6

(a) **Tests of control**

A test of control tests the operating effectiveness of controls in preventing, detecting or correcting material misstatements.

It is important for the external auditor to test controls to ensure their initial understanding obtained when assessing the control environment and internal controls is appropriate.

This will allow the auditor to identify and assess the risks of material misstatements in the financial statements and determine the amount of reliance that can be placed on the controls.

The auditor is then able to design substantive audit procedures to reduce detection risk, and therefore audit risk, to an acceptable level.

(b) **Direct controls and tests of control**

Direct control (i)	Test of control (ii)
All staff are assigned a unique ID card by the personnel department to record hours worked. Segregation of duties between allocating the cards and processing payroll will reduce the risk of fraud such as the creation of 'ghost' employees by the payroll department.	Ask a sample of employees to confirm who provided them with their unique ID card on joining the business. Inspect the ID cards for existence. Agree the employee details to HR records.

Hours worked are authorised by divisional heads. There is a reduced risk that hours are overstated as the divisional head is more likely to identify errors or anomalies. This reduces the risk of incorrect payments being made which will cause misstatement of payroll costs.	Inspect the emails sent each month by the head of division authorising the hours worked.
The payroll system is password protected with an alphanumerical password known only to the payroll clerk and finance manager. The password is difficult to guess and therefore will limit the risk of unauthorised access which could lead to payroll data being manipulated and payroll costs being misstated. This reduces the risk of fraud and loss to the company.	The auditor should use test data and enter a 'dummy' password into the payroll system to ensure that access is not granted.
Payroll calculations are automatically calculated by the standardised payroll software. Calculation by the system is less vulnerable to error. This ensures accuracy of payroll costs and minimises the risk of incorrect payments being made which could result in dissatisfied employees.	The auditor should recalculate a sample of employee's monthly pay from across the year and compare to the calculations on the payroll report for those months.
The finance manager reviews the payroll report and compares to last month before the final payroll is processed. The comparison of data to the prior month should highlight any errors before the payroll is processed. This reduces the risk of incorrect payments being made to employees which could result in misstatement of payroll and dissatisfied employees.	For a sample of months, inspect the payroll reports for evidence of the finance manager's signature confirming that the review has been performed.
Payslips are sent to the home address of each employee. This should reduce the risk that payslips are misplaced or manipulated. It would also reduce the risk of a confidentiality breach.	Ask a sample of employees to confirm they receive their monthly payslips via post to their home address. Observe the process of sending payslips to employees.

Test your understanding 7

1	C	Segregation of duties helps to prevent fraud.
2	D	Enquiry is not the most reliable form of evidence as the clerk or the manager could say what they think the auditor wants to hear. Recalculation of payroll by the auditor is a substantive test and does not confirm the manager has performed the necessary checks.
3	A	Inspection of employee contracts to confirm salary details is a substantive procedure.
4	B	The department manager would identify if any fictitious employees or employees who had left the company were included on the list and could notify the payroll department before any invalid payments were made.
5	A	Internal audit can monitor the effectiveness of controls by regularly testing them. B, C and D are all examples of control activities that would be tested for effectiveness.

Test your understanding 8

1	C	The auditor must ensure the systems documentation held on file is still correct. This can be achieved through a combination of enquiry and walkthrough tests but enquiry alone is not sufficient appropriate evidence.
2	B	Tests of controls must be performed when the auditor is planning to place reliance on controls over areas of significant risk. If the auditor has decided that substantive testing is more efficient for a specific balance, it is not necessary to test the controls over that area. Reliance can be placed on the results of tests of controls performed in previous years to some extent, however, the auditor must perform tests of controls over some areas. For areas where controls are not tested this year, the auditor must ensure they are tested within a three-year cycle.
3	D	An internal control evaluation questionnaire asks the client to respond with the control in place that addresses a risk. Restricted access as given in answer D is a control. This question would be included in an internal control questionnaire rather than an internal control evaluation questionnaire.
4	A	The external auditor should not monitor the controls, as this requires ongoing involvement in the company on a regular basis. Whilst the external auditor may test the controls and identify deficiencies, this does not constitute monitoring. Management is ultimately responsible for the internal controls including assessing whether they are effective and whether any improvements are required. They may utilise an external consultant or internal audit function to help them fulfil this responsibility.
5		**Flowchart** – a diagram depicting controls in place at each stage **ICQ/ICE** – a disadvantage of this method may be that controls are overstated **ICQ/ICE** – An advantage of this method is that they are easy to prepare in advance and therefore efficient **Narrative notes** – For larger systems this method may be time consuming and it may be difficult to identify missing controls

Chapter

9

Internal audit

Chapter learning objectives

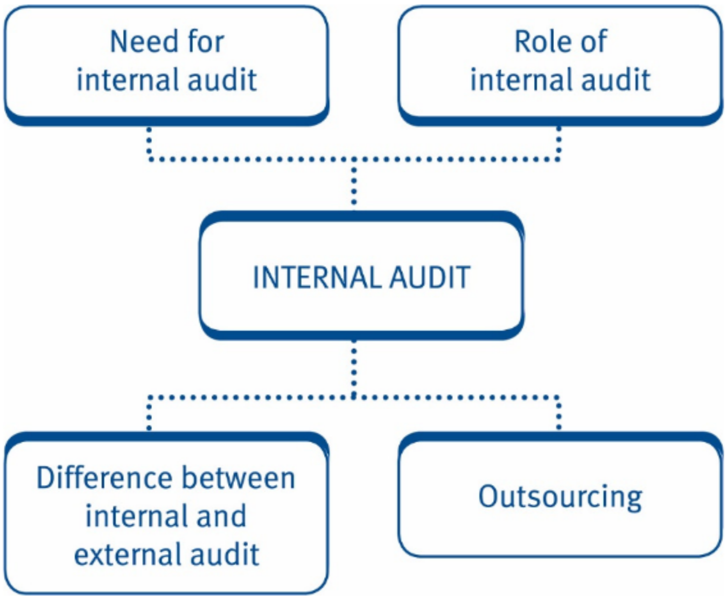
This chapter covers syllabus areas:

- C5 – Internal audit and governance, and the differences between external audit and internal audit
- C6 – The scope of the internal audit function, outsourcing and internal audit assignments

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO19) is to collect and evaluate evidence for an audit. Carry out an internal or external audit from collecting evidence, through to forming an opinion. You demonstrate professional scepticism and make sure judgements are based on sufficient valid evidence. Working through this chapter should help you understand how to demonstrate that objective.



1 The need for internal audit

Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations.

A company must create a strong system of internal control in order to fulfil its responsibilities.

However, it is not sufficient to simply have mechanisms in place to manage a business, the effectiveness of those mechanisms must be regularly evaluated. All systems need some form of monitoring and feedback. This is the role of internal audit.

Having an internal audit department is generally considered to be best practice, but is not required by law. This allows flexibility in the way internal audit is established to suit the needs of a business.

In small, or owner managed businesses there is unlikely to be a need for internal audit because the owners are able to exercise more direct control over operations, and are accountable to fewer stakeholders.

The need for internal audit (IA) therefore will depend on:

- Scale and diversity of activities. In a larger, diversified organisation there is a risk that controls don't work as effectively because of the delegation of responsibility down the organisation. Internal audit can report back to the audit committee if controls are not as effective as they should be.
- Complexity of operations. The more complex the organisation is, the greater the benefit obtained from having an IA function as there is greater risk of things going wrong. With larger organisations the consequences of poor controls/risk management/corporate governance practices are likely to be greater.

- Number of employees. The greater the number of employees the greater the risk of fraud.
- Cost/benefit considerations. It will be worthwhile establishing an IA function if the benefits outweigh the costs. For example, a company might be losing money as a result of fraud, not using the most cost effective or reliable suppliers, or incurring fines for non-compliance with laws and regulations. If these costs outweigh the cost of employing an IA function it will be beneficial to the company to establish a department.
- The desire of senior management to have assurance and advice on risk and control. The directors may wish to have the comfort that there is ongoing monitoring of the organisation to help them discharge their responsibilities.
- The current control environment and whether there is a history of fraud or control deficiencies. If so it will be beneficial for the company to establish an internal audit function to prevent and detect fraud.

2 The difference between internal and external auditors

	External audit	**Internal audit**
Objective	Express an opinion on the truth and fairness of the financial statements in a written report.	Improve the company's operations by reviewing the efficiency and effectiveness of internal controls.
Reporting	Reports to shareholders.	Reports to management or those charged with governance.
Availability of report	Publicly available.	Not publicly available. Usually only seen by management or those charged with governance.
Scope of work	Verifying the truth and fairness of the financial statements.	Wide in scope and dependent on management's requirements.
Appointment and removal	By the shareholders of the company.	By the audit committee or board of directors.
Relationship with company	Must be independent of the company.	May be employees (which limits independence) or an outsourced function (which enhances independence).

3 The role of the internal audit function

The role of internal audit can vary depending on the requirements of the business.

Key activities of the internal audit function

- Assessing whether the company is demonstrating best practice in corporate governance.
- Evaluating the company's risk identification and management processes.
- Testing the effectiveness of internal controls.
- Assessing the reliability of financial and operating information.
- Assessing the economy, efficiency and effectiveness of operating activities (value for money).
- Assessing compliance with laws and regulations.
- Providing recommendations on the prevention and detection of fraud.

Most of these activities can be seen as helping management comply with corporate governance requirements.

Additional roles

In addition to the above, internal audit will carry out ad hoc assignments, as required by management. For example:

- Fraud investigations – this may involve detecting fraud, identifying the perpetrator of a fraud and quantifying the loss to the company as a result of a fraud.
- IT systems reviews – performing a review of the computer environment and controls.
- Mystery shopper visits – for retail and service companies the internal audit staff can pose as customers to ensure that customer service is at the required level.
- Contract audits – making sure that where significant or long term contracts are entered into by the organisation, the contract is written to protect the organisation appropriately and contractual terms are being adhered to by the supplier in line with the service level agreement.
- Asset verification – such as performing cash counts and physical inspection of non-current assets to verify existence.
- Providing direct assistance to the external auditor – internal audit staff can help the external auditor with their procedures under supervision, in accordance with ISA 610. This is covered in the 'Evidence' chapter.

Qualities of an effective internal audit function

- Sufficiently resourced, both financially and in terms of qualified, experienced staff.
- Well organised, so that it has well developed work practices.
- Independent and objective to provide an unbiased view of the organisation's operations.
- The chief internal auditor should be appointed by the audit committee to reduce management bias.
- The department should have no operational responsibilities to reduce the threat of self-review.
- The audit committee should set the plan of work.
- There should be no limitation on the scope of their work i.e. full access to every part of the organisation.

Limitations of internal audit

- Internal auditors may be employees of the company they are reporting on and therefore may not wish to raise issues in case they lose their job.
- In smaller organisations in particular, internal audit may be managed as part of the finance function. They will therefore have to report on the effectiveness of financial systems of which they form a part and may be reluctant to say their department (and manager) has deficiencies.
- If the internal audit staff have worked in the organisation for a long time, possibly in different departments, there may be a familiarity threat as they will be auditing the work of long standing colleagues and friends.

It is therefore difficult for internal audit to remain truly objective. However, acceptable levels of independence can be achieved through one, or more, of the following strategies:

- Reporting channels separate from the management of the main financial reporting function.
- Reviews of internal audit work by managers independent of the function under scrutiny.
- Outsourcing the internal audit function to a professional third party.

4 Outsourcing the internal audit function

In common with other areas of a company's operations, the directors may consider that outsourcing the internal audit function represents better value than an in-house department.

Outsourcing is where the company uses an external company to perform its internal audit service instead of employing its own staff.

Advantages

- Professional firms follow an ethical code of conduct and should therefore be independent of the client.
- Professional firms should have qualified, competent staff who receive regular development and have a broader range of expertise.
- An outsourcing firm will have specialist skills readily available therefore outsourcing can be used to overcome a skills shortage.
- Professional firms can be employed on a flexible basis, i.e. on an individual engagement basis rather than full time employment which may prove more cost effective.
- Employment costs of permanent staff are avoided.
- The risk of staff turnover is passed to the outsourcing firm.
- Professional firms are responsible for their activities and hold insurance.
- There is likely to be greater focus on cost and efficiency of the internal audit work as this will affect profitability of the assignment.
- The company will obtain access to new market place technologies without the associated costs, e.g. data analytic tools and audit software.
- Management time in administering an in-house department will be reduced.

Disadvantages

- Professional firms lack the intimate knowledge and understanding of the organisation that employees have.
- The decision may be based on cost with the effectiveness of the function being reduced.
- Engagements with professional firms are constrained by contractual terms. Flexibility and availability may not be as high as with an in-house function.
- Fees charged by professional firms may be high.
- An ethical threat may arise if the service is provided by the external audit firm. E.g. the ACCA Code of Ethics and Conduct prohibits external auditors of a listed company from providing internal audit services for the same client where the service relates to financial reporting systems.
- Pressure on the independence of the outsourced function, for example, if management threaten not to renew the contract.
- Lack of control over the quality of service.

5 Internal audit assignments

Internal auditors perform many different types of assignment. Common examples include:

- Value for money assignments
- Operational audits
- The audit of IT systems
- Financial audit.

Value for money

Value for money (VFM) is concerned with obtaining the best possible combination of services for the least resources. It is often referred to as a review of the three Es:

- **Economy** – obtaining the best quality of resources for the minimum cost.
- **Efficiency** – obtaining the maximum departmental/organisational outputs with the minimum use of resources.
- **Effectiveness** – achievement of goals and targets (departmental/organisational etc.).

Comparisons of value for money achieved by different organisations (or branches of the same organisation) are often made using performance indicators that provide a measure of economy, efficiency or effectiveness. This is particularly common in the not-for-profit sector (i.e. public services and charities), but it can apply to any company.

For example, a company chooses the cheapest supplier for the materials it needs. The supplier has a lead time for delivery of 6 weeks. If the company needs a supplier that can deliver at short notice on a regular basis this will not be effective.

If a company sources lower quality materials at a price 10% cheaper than its current supplier but uses 50% more as a result of the lower quality, this is not efficient.

e.g

Value for money: hospital

Examples of value for money indicators for a hospital might include:

- Economy – cost of medical supplies per annum.
- Efficiency – number of patients treated per year, utilisation rate of beds/operating theatre.
- Effectiveness – recovery rates, number of deaths.

Operational audits

An operational audit is a systematic review of the efficiency and effectiveness of operations within the organisation. The focus of the audit is on the processes which take place within the organisation to identify if they can be streamlined and performed more efficiently. The more efficient a process is, the more profitable the organisation should be.

For example, during an operational audit the internal auditor may find that orders are manually entered into a sales system to record an order. A copy of the order is passed to the despatch department who manually enter the details into the despatch system. A copy of the goods despatch note is sent to the finance department for invoicing and the details are manually entered into the invoice.

In addition to the risk of error that arises each time the details are manually entered, this is a time consuming and inefficient process.

The internal auditor may recommend that an integrated system is introduced to remove the need for the data to be entered by each department. If the order system links to the despatch system and the despatch system links to the finance system, no manual entry will be required after the order has been entered in the first instance.

The audit of IT systems

The external auditor considers IT systems from the perspective of whether they provide a reliable basis for the preparation of financial statements, and whether there are internal controls which are effective in reducing the risk of misstatement.

Internal audit will also consider this, however, its role is much wider in scope and will also consider whether:

- the company is getting value for money from its IT system.
- the procurement process for the IT system was effective.
- the ongoing management/maintenance of the system is appropriate.

Whilst this is an ongoing role, project auditing can be used to look at whether the objectives of a specific project, such as implementing new IT systems, were achieved.

Financial audit

The main aim of a financial reporting system is to create accurate, complete and timely information which can be used for decision making and business planning. This information is also needed to satisfy the requirements of actual and potential investors and trading partners.

Typical examples of financial information include:

- Financial statements
- Monthly management accounts
- Forecasts and projections.

The main aim of internal financial audits is to ensure that the information produced is reliable and produced in an efficient and timely manner. If not, executive decisions may be based on unreliable information.

The other aim of a financial audit is to assess the financial health of a business. More importantly it is about ensuring there are mechanisms in place for the early identification of financial risk, such as:

- Adverse currency fluctuations
- Adverse interest rate fluctuations
- Cost price inflation.

In both cases the focus of internal audit will be on the processes and controls that underpin the creation of the various financial reports to ensure they are as effective as possible for assisting decision making and the risk management processes of the company.

6 Reporting

Unlike an independent external auditor's report, the internal audit report does not have a formal reporting structure. It is likely that the format is agreed with the audit committee or board of directors prior to commencing the assignment.

These reports will generally be for internal use only. The external auditors may inspect them if they are intending to place reliance on the work of internal audit.

A typical report will include:

- Terms of reference – the requirements of the assignment.
- Executive summary – the key risks and recommendations that are described more fully in the body of the report.
- Body of the report – a detailed description of the work performed and the results of that work.
- Appendix – containing any additional information that doesn't belong in the body of the report but which is relevant to the assignment.

In the exam you may be asked to take the role of an internal auditor performing an audit assignment to test controls or identify improvements in efficiency that can be made.

The internal audit report can be set out in the same way as the report to management that has been seen in the 'Systems and controls' chapter, describing the deficiencies identified, consequences of those deficiencies and recommendations for improvement.

Test your understanding 1

Murray Co's internal audit function

The internal audit function at Murray Co consists of a head of internal audit, two senior internal audit managers, four internal audit managers, seven internal auditors and an internal audit assistant. The head of internal audit has been in post for twelve years, and the other members of the team have varying lengths of service from two to fifteen years.

The head of internal audit is responsible for recruiting staff into the internal audit team. The head of internal audit was appointed by the audit committee.

The head of internal audit reports to the audit committee and agrees the scope of work for the internal audit function with the audit committee.

The internal audit staff have no operational responsibility. Where the staff have previously transferred from another department within Murray Co, the head of internal audit ensures that another member of the team carries out the audit of that system.

Murray Co's internal audit function follows the International Standards for the Professional Practice of Internal Auditing issued by the Global Institute of Internal Auditors.

Barker Co's internal audit function

The internal audit function at Barker Co consists of a chief internal auditor, one senior internal audit manager, one audit manager, one auditor and an audit assistant. The chief internal auditor has been in post for ten years, and the other members of the team have varying lengths of service from five to nine years.

The finance director is responsible for recruiting all staff into the internal audit function. The chief internal auditor reports to the finance director and they agree the scope of the work for the internal audit function together.

The internal audit team spend 50% of their time carrying out internal audit assignments and 50% of their time working in the finance department. Due to the limited number of staff in the team, this has resulted in the internal auditors reviewing their own work.

Barker Co's internal audit team follow a variety of standards, in accordance with their own professional training.

Required:

Compare and contrast the effectiveness of Murray Co and Barker Co's internal audit functions.

(6 marks)

Test your understanding 2

You are the senior manager in the internal audit department of Octball Co, a limited liability company. You report to the chief internal auditor and have a staff of six junior auditors to supervise, although the budget allows for up to ten junior staff.

In a recent meeting with the chief internal auditor, the difficulty of staff recruitment and retention was discussed. Over the past year, five junior internal audit staff have left the company, but only two have been recruited. Recruitment problems identified include the location of Octball Co's head office in a small town over 150 kilometres from the nearest major city and extensive foreign travel, often to cold climates.

Together with the chief internal auditor you believe that outsourcing the internal audit department may be a way of alleviating the staffing problems. You would monitor the new outsourced department in a part-time role taking on additional responsibilities in other departments, and the chief internal auditor would accept the post of finance director (FD) on the board, replacing the retiring FD.

Two firms have been identified as being able to provide the internal audit service:

- The NFA Partnership (NFA), a large local firm specialising in the provision of accountancy and internal audit services. NFA does not audit financial statements or report to members.
- T&M, Octball Co's external auditors, who have offices in 75 countries and employ in excess of 65,000 staff.

Required:

(a) Discuss the advantages and disadvantages of appointing NFA as internal auditors for Octball Co.

(8 marks)

(b) Discuss the matters T&M need to consider before they could accept appointment as internal auditors for Octball Co.

(7 marks)

(c) Assume that an outsourcing company has been chosen to provide internal audit services. Describe the control activities that Octball Co should apply to ensure that the internal audit service is being maintained to a high standard.

(5 marks)

(Total: 20 marks)

Test your understanding 3

You are an audit senior working at Monkey, Mia & Co. You have been seconded to your firm's internal audit department to broaden your experience. You have been assigned to an internal audit assignment to test the effectiveness of the computer systems at a large company. Your firm won the contract to provide internal audit services to the company after the company took the decision to outsource its internal audit function and make the existing internal audit staff redundant.

1 **With which of the following should the internal auditor not be involved?**

A Identifying deficiencies in internal controls

B Providing recommendations to management on how to overcome the deficiencies identified

C Implementing the new controls recommended

D Evaluating the effectiveness of the new controls implemented

2 **Which TWO of the following statements are TRUE?**

(i) Internal auditors always report directly to shareholders.

(ii) The format of the independent external auditor's report is determined by management.

(iii) The internal auditor's work may be determined by management.

(iv) All external audits must be planned and performed in accordance with International Auditing Standards and other regulatory requirements.

A (i) and (iv)

B (i) and (iii)

C (ii) and (iii)

D (iii) and (iv)

3 **Which of the following is NOT part of the role of internal audit?**

A Risk identification and monitoring

B Expression of opinion to the shareholders on whether the annual financial statements give a true and fair view

C Fraud investigations

D Assessing compliance with laws and regulations

4 **Which of the following is NOT a valid reason to outsource the internal audit function?**

A The external audit will be more efficient as the external audit staff will have a good understanding of the company if they are also involved with the internal audit work

B Outsourcing may be more cost effective as compared with employing staff and providing training and other employment benefits

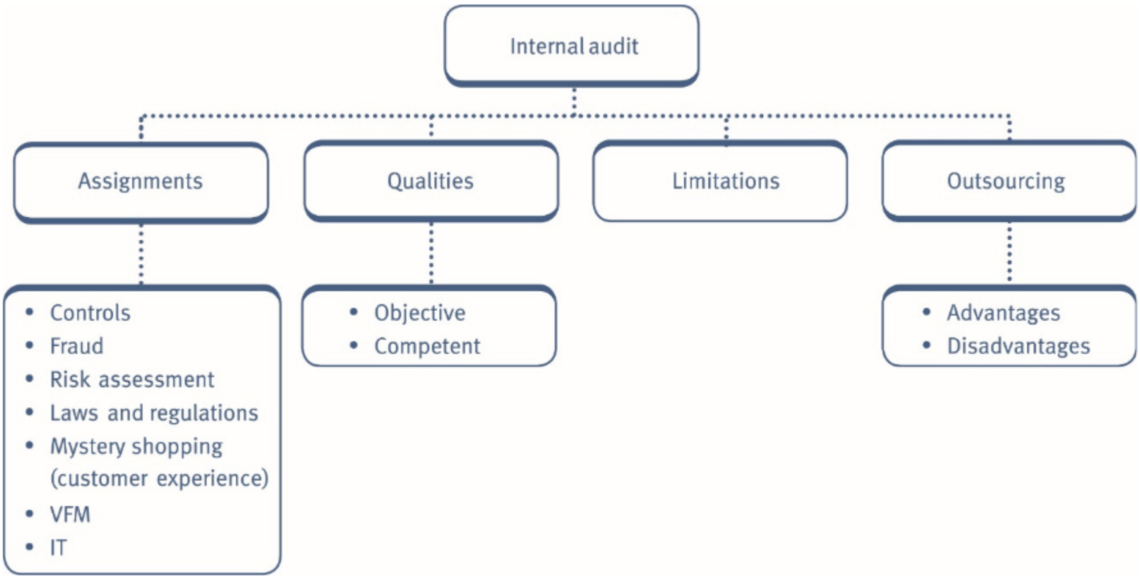
C A professional firm is likely to be more experienced and able to provide better recommendations for improvements

D Greater independence of an external service provider

5 **Identify whether the following statements are true or false.**

Internal audit reports must be produced in a standardised format as set out by the financial reporting framework	**True**	**False**
Internal audit reports are issued to shareholders	**True**	**False**
There is no legal requirement for companies to have an internal audit department	**True**	**False**
The presence of an internal audit function may act as a deterrent for fraud	**True**	**False**

7 Chapter summary



Test your understanding answers

Test your understanding 1

Reporting system

The chief internal auditor at Barker Co reports into the finance director. This limits the effectiveness of the internal audit reports as the finance director will also be responsible for some of the financial systems that the internal audit function is reporting on. Similarly, the chief internal auditor may soften or limit criticism in reports to avoid confrontation with the finance director.

To ensure independence, the chief internal auditor should report into the audit committee, as at Murray Co.

Recruitment of staff

All of the internal audit team at Barker Co are recruited by the finance director. The finance director may appoint personnel who are less likely to be critical of the work of the finance function. To ensure independence, the head of internal audit should be appointed by the audit committee, and they should then recruit and appoint the rest of the team, as at Murray Co.

Scope of work

The scope of work of internal audit at Barker Co is decided by the finance director in discussion with the chief internal auditor. This means that the finance director may try and influence the chief internal auditor regarding the areas that the internal audit department is auditing, possibly directing attention away from any contentious areas that the director does not want auditing.

To ensure independence, the scope of work of the internal audit department should be decided by the chief internal auditor, perhaps with the assistance of an audit committee, as at Murray Co.

Audit work

The internal audit team at Barker Co review their own work. This limits independence as the auditor may overlook or fail to identify errors or deficiencies in those areas. This is a self-review threat.

If possible, the internal audit team should not have operational responsibility. However, if this is not possible, the internal audit work should be arranged as at Murray Co, so that no member of the team reviews areas where they have operational responsibility.

Lengths of service of internal audit staff

The internal audit staff of both companies have been employed for a long time. This may limit their effectiveness as they will be very familiar with the systems being reviewed and therefore may not be sufficiently objective to identify errors in those systems.

However, there are sufficient staff at Murray Co to ensure that the team can be rotated into different areas of internal audit work, and their work can be independently reviewed. Due to the small number of staff in the internal audit team, Barker Co may not be able to achieve this.

Given the extent of limitations, it may be appropriate for Barker Co to outsource its internal audit function.

Variation of standards

Staff at Barker Co follow the auditing standards with which they are familiar. Standards of internal audit are not uniform across the profession. This could lead to inconsistency in the way each internal audit assignment is performed. This can lead to manipulation of internal audit aims and measurement. Barker Co should follow an agreed, recognised set of professional internal audit standards, such as those followed by Murray Co.

Test your understanding 2

(a) **Benefits of outsourcing to NFA**

Expertise available

NFA will be able to provide the necessary expertise for internal audit work. They may be able to provide a broader range of expertise as they serve many different clients, therefore staff may be available for specialist work that Octball Co could not afford to employ.

Obtain skills as and when required

If internal audit is only required for specific functions or particular jobs each year then the expertise can be purchased as required. Taking this approach will minimise in-house costs.

Independence

As an independent firm which does not perform the audit of the financial statements, it is likely that they can provide a high level of service with appropriate objectivity. In particular, there will be no self-review threats.

Audit techniques – training

Outsourcing will remove the need for training internal staff. The outsourcing firm will be responsible for training its staff and keeping them up-to-date with new auditing techniques and processes.

Continuity of service – staffing

As provision of internal audit services is NFA's main activity, they should also be able to budget for client requirements. As a larger internal auditing firm, they may be able to offer staff better career progression which should assist staff retention.

Problems with outsourcing to NFA

Fee pressure

NFA may experience some fee pressure, but only in respect of maintaining cost effectiveness of the internal audit department. The relationship needs to be managed carefully to ensure that NFA does not decrease the quality of its work due to insufficient fees.

Knowledge

NFA will not have any prior knowledge of Octball Co. This is a disadvantage as it will mean the partnership will need time to ascertain the accounting systems and controls in Octball Co before commencing work. However, provision of an independent view may identify control deficiencies that the current internal audit department have missed.

Location

NFA may not be able to provide this service to Octball Co as they are a local firm and therefore the issue of travel and working away from home would remain.

(b) **Matters to be considered by T&M**

Independence

T&M need to ensure that independence can be maintained in a number of areas:

- Independence regarding recommending systems or preparing working papers and subsequent checking of those systems or working papers. While the internal audit department may need to carry out these functions, T&M must ensure that separate staff are used to provide the internal and external audit functions.
- Staff from T&M will be expected to follow the ethical guidance of ACCA which means that steps will be taken to avoid conflicts of interest or other independence issues such as close personal relationships building up with staff in Octball Co. Any real or perceived threats to independence will lower the overall trust that can be placed on the internal audit reports produced by T&M.

Skills

T&M must ensure that it has staff with the necessary skills and sufficient time to undertake the internal audit work in Octball Co. As a firm of auditors, T&M will automatically provide training for its staff as part of the in-house compliance with association regulations (e.g. compulsory CPD). T&M will need to ensure that staff providing the internal audit function to Octball Co are aware of relevant guidance for internal auditors.

Fee pressure

There may be fee pressure on T&M, either to maintain the cost effectiveness of the internal audit department, or to maintain the competitiveness of the audit fee itself in order to keep the internal audit work.

Knowledge

As the external auditor, T&M will already have knowledge of Octball Co. This will assist in establishing the internal audit department as systems documentation will already be available and the audit firm will already be aware of potential deficiencies in the control systems.

(c) **Controls to maintain the standard of the internal audit department**

– If T&M is appointed, the internal and external audits should be performed by different departments within the firm.

– Performance measures such as cost, areas reviewed, etc. should be set and reviewed. Explanations should be obtained for any significant variances.

– Appropriate audit methodology should be used, including clear documentation of audit work carried out, adequate review, and appropriate conclusions drawn.

– Working papers should be reviewed, ensuring adherence to International Standards on Auditing where appropriate and any in-house standards on auditing.

– The work plan for internal audit should be agreed prior to the work commencing and this should be followed by the outsourcing company.

Test your understanding 3

1	C	Internal auditors should not implement new controls as this would create a self-review threat when the controls are tested at a later date.
2	D	Internal audit work may be determined by management or the audit committee if there is one. External audits must be conducted in accordance with ISAs.
3	B	An audit opinion presented to the shareholders must be expressed by an independent external auditor.
4	A	Ethical guidance issued to external auditors requires separate teams to provide internal and external services. Therefore the internal audit staff assigned will not have existing knowledge gained from the external audit.

5

Internal audit reports must be produced in a standardised format as set out by the financial reporting framework	**True**	**False**
Internal audit reports are issued to shareholders	**True**	**False**
There is no legal requirement for companies to have an internal audit department	**True**	**False**
The presence of an internal audit function may act as a deterrent for fraud	**True**	**False**

Chapter

10

Procedures

Chapter learning objectives

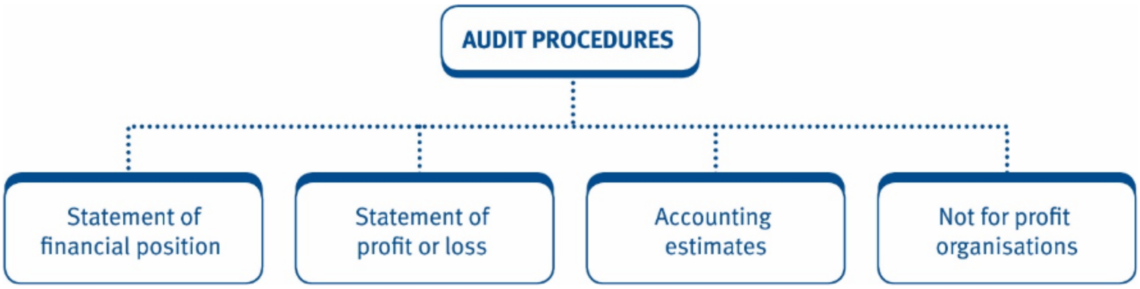
This chapter covers syllabus areas:

- D2 – Audit procedures
- D4 – The audit of specific items
- D7 – Not-for-profit organisations

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO19) is to collect and evaluate evidence for an audit. Carry out an internal or external audit from collecting evidence, through to forming an opinion. You demonstrate professional scepticism and make sure judgements are based on sufficient valid evidence. Working through this chapter should help you understand how to demonstrate that objective.



1 Exam focus

We dealt with the principles of audit evidence in an earlier chapter. This chapter deals with the **application** of those principles.

Audit procedures must be designed to respond to the specific risks of material misstatement identified for each individual client. In the exam, you should make your answers specific to the scenario. It is highly likely the scenario focuses on a specific risk such as valuation of inventory, recoverability of receivables, etc. Therefore audit procedures must focus on these features rather than general audit procedures over the balance in question.

Remember that the auditor's role is to obtain sufficient appropriate evidence that the financial statements are prepared in all material respects with the relevant financial reporting framework. For this reason, you will need to have a good understanding of the accounting standards.

Writing good audit procedures

An audit procedure should be a clear instruction of how the audit evidence is to be gathered.

It should contain an ACTION applied to a SOURCE to achieve an OBJECTIVE.

In other words, it should describe what needs to be done, how it should be done and why it should be done.

Read the procedure back and consider whether a person with no audit experience will understand it.

Example: Audit objective − Test the existence of non-current assets

Good answer	Bad answer
Select a sample of assets from the non-current asset register and physically inspect them to verify existence.	Check a sample of assets.
Explanation	
The good procedure above clearly states: • from where the sample should be chosen – the non-current asset register • how they should be checked – physically inspect • the objective of the test – existence	The badly worded procedure is not sufficiently described: • From which population should the sample be selected? • How should the auditor 'check' existence? • What are the assets being checked for?

Example: Audit objective − Test the valuation of trade receivables

Good answer	Bad answer
Inspect post-year-end bank statements to identify if payment has been received post year end. If so, agree the amount to the trade receivables account at the year end.	Perform a receivables circularisation for a sample of customers to confirm the balances are in existence at the year end.
Explanation	
The good answer is a well explained procedure which tests the assertion of valuation in relation to receivables.	The bad answer tests the assertion of existence, not valuation. It is a well written procedure, but not relevant for the stated audit objective.

This chapter is a starting point to help you familiarise yourself with the basic auditing techniques, to allow you to apply them to questions. It is not an exhaustive summary of all audit procedures.

Each section starts with:

Key assertions − these are the assertions most likely to be at risk, however, the auditor must obtain assurance over all relevant assertions.

Sources of evidence − these are the documents that are likely to provide the best evidence over the balance being tested.

There are several ways to design audit procedures:

- Identify the financial statement assertion to be tested.

  E.g. to test accuracy of a sale the auditor will need to agree the amount on the sales invoice matches the amount recorded in the detailed sales listing.

- Identify the sources of evidence available.

  E.g. when testing payroll, evidence can come from payslips issued to employees. The auditor can agree amounts recorded on the payslip to the amounts recorded in the payroll payment list.

- Identify the types of procedure the auditor can use from ISA 500.

  E.g. analytical procedures. When testing receivables, the auditor may calculate the receivables collection period and compare it with the prior year to identify any unusual variation.

2 Directional testing

The concept of directional testing derives from the principle of double-entry bookkeeping, i.e. for every debit there should be a corresponding credit.

Directional testing reduces duplication and therefore over-auditing and allows for a more efficient audit. Applying this concept, any misstatement of a debit entry will also result in a misstatement of a credit entry, e.g. directly testing payables for understatement also indirectly tests expenses/cost of sales for understatement.

It is important for the auditor to apply directional testing from the start of the transaction to the end (testing for understatement) and then again in reverse (testing for overstatement) as a directional test will not be effective if the sample is chosen from the wrong population.

Testing for understatement

A balance will be understated if:

- Items that should be included are not included i.e. the balance is not complete, or
- An item which has been included is recorded at an amount lower than it should be i.e. the amount is misstated.

Testing for understatement tests the assertions of completeness and accuracy & valuation.

To test for understatement, the auditor must select the sample from outside of the accounting system and trace the transaction through to the accounting system and into the financial statements.

For example, select a sample of goods despatch notes and trace to the related sales invoice and into the detailed sales listing to confirm completeness. Finally, the total of the detailed sales listing must be agreed to the revenue figure in the financial statements.

Testing for overstatement

A balance will be overstated if:

- Items are included that should not be included, or
- An item which has been included is recorded at an amount higher than it should be i.e. the amount is misstated.

Testing for overstatement tests the assertions of existence, rights and obligations, occurrence and accuracy & valuation.

To test for overstatement, the auditor must first of all agree the figure in the financial statements to the accounting system, then select a sample of transactions from the accounting system to the relevant supporting documentation.

For example, agree the revenue figure in the financial statements to the detailed sales listing, then select a sample of sales invoices from the detailed sales listing and trace to the actual sales invoice and related goods despatch note to confirm occurrence.

3 Bank and cash

The key assertions for bank and cash are existence and valuation.

Sources of evidence:

- Bank confirmation letter
- Bank reconciliation
- Bank ledger account
- Bank statements

The bank and cash included in the financial statements must exist and be included at the appropriate amount. The bank ledger account figure is the balance which should be included in the financial statements. This may differ to the bank statement balance due to timing differences. Therefore, the bank reconciliation must be reviewed to ensure the differences can be explained.

The bank confirmation letter provides direct confirmation of bank balances from the bank. It is third party, independent, written evidence and therefore very reliable.

The client must give permission to the bank to release this information to the auditor, as they too have a duty of confidentiality to their clients.

The confirmation request should be sent a minimum of two weeks before the client's year end. The letter should include enough information to allow the bank to trace the client. The confirmation letter will be sent by the bank directly to the auditor's office.

Test your understanding 1 – Bank and cash

Murray Co

Bank reconciliation as at 31 December 20X4	$
Balance per bank ledger account	(180,345.22)
Add Unpresented cheques	2,223.46
Less Outstanding lodgements	(1,600.34)
Difference	1.34
	–––––––––
Balance per bank statement	(179,720.76)
	–––––––––

Required:

Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Murray Co's year-end bank balances.

Illustration 1 – Murray Co Bank confirmation letter

Wimble & Co
14 The Grove
Kingston
KI4 6AP

Manager (Audit Confirmations)
National Bank Anytown Branch
High Street, Anytown, AT1 1 HS

14 December 20X4

Dear Sir,

Re: Murray Co

In accordance with the agreed practice for provision of information to auditors, please forward information on our mutual client as detailed below on behalf of the bank, its branches and subsidiaries. This request and your response will not create any contractual or other duty with us.

Company name: Murray Co

Main account number: 01789311

Sort code: 04-83-12

Information required

- Standard **x**
- Trade finance **x**
- Derivative and commodity trading
- Custodian arrangements
- Other information (see attached)

Audit confirmation date: 31/12/X4

The Authority to Disclose Information signed by your customer is already held by you. This is dated 30/11/X4. Please advise us if this Authority is insufficient for you to provide full disclosure of the information requested.

The contact name is: Don Henman (Audit engagement partner)

Telephone: 01234 123456

Yours faithfully,

Wimble & Co

Wimble & Co

Cash counts

Where cash in hand is material, or when fraud is suspected, a cash count should be arranged to verify existence.

The auditor should make sure that all cash balances are counted at the same time to avoid manipulation of the balances between different sites.

The auditor should always be accompanied by a member of the client staff to avoid any allegations from the client of theft by the auditor.

The details of the cash counts should be recorded, such as the locations counted, the amount counted at each location, the client staff present, the auditor performing the tests and the date performed.

Non-current liabilities

The key assertion for liabilities is completeness and valuation.

Sources of evidence:

- Loan agreement
- Bank ledger account
- Bank statements
- Bank confirmation letter

The loan balances must be complete and valued appropriately in the financial statements. Allocation must be assessed as the client should show how much of the loan is due to be paid within one year (included as a current liability) and how much of the loan is due to be paid outside of one year (included as a non-current liability).

The bank confirmation letter will provide details of loans held, the amounts outstanding, accrued interest and any security provided in relation to those loans.

Third-party evidence will be available in the form of the bank confirmation letter and the original loan agreement.

Procedures include:

- Obtain a breakdown of all loans outstanding at the year end, cast to verify arithmetical accuracy and agree the total to the financial statements: **completeness**.
- Agree the balance(s) outstanding to the bank confirmation letter: **accuracy & valuation, rights & obligations**.
- Inspect the bank confirmation letters for any loans listed that have not been included in the financial statements: **completeness**.
- Inspect the bank confirmation letter for details of any security over assets and agree the details to the disclosure in the financial statements: **presentation**.
- Inspect financial statements for disclosures of interest rates, and the split of the loan between current and non-current: **allocation, classification**, **presentation**.
- Recalculate the split between current and non-current liabilities: **allocation, classification, and presentation**.
- Inspect the loan agreement for restrictive covenants (terms) and determine the effect of any loan covenant breaches: **allocation, classification, presentation.** [If loan covenants have been breached the loan may become repayable immediately and should therefore be included as a current liability].
- Inspect the bank ledger account for loan repayments made: **existence, accuracy & valuation**.
- For the related finance cost in the statement of profit or loss, recalculate the interest charge and any interest accrual in accordance with terms within the loan agreement, to ensure mathematical accuracy: **accuracy** of finance costs in the statement of profit or loss, **completeness** of accruals.

4 Non-current assets

The key assertions for non-current assets are existence, valuation, completeness and rights and obligations.

Sources of evidence:

- Non-current asset register
- Purchase invoices (additions)
- Sales invoices/asset disposal forms (disposals)
- Bank statements and bank ledger account
- Physical assets
- Ownership documents including title deeds and registration documents
- Depreciation policy and rates
- Asset expenditure budgets/asset replacement plans

Non-current assets must exist, be completely recorded, be valued appropriately and must be owned or controlled by the entity.

The auditor needs to obtain sufficient appropriate evidence over:

- Existing assets i.e. assets purchased in previous periods
- Additions
- Disposals
- Revaluations
- Depreciation
- Related disclosures (the property, plant and equipment note, depreciation policies, useful economic lives, revaluations).

Test your understanding 2 – Non-current assets

Murray Co

Non-current assets: Property, plant and equipment note

	Land & buildings	Fixtures, fittings & equipment	Motor vehicles	Total
	$000	$000	$000	$000
Cost at 1 January 20X4	3,000	2,525	375	5,900
Additions	–	1,050	75	1,125
Disposals	–	(300)	–	(300)
Cost at 31 December 20X4	3,000	3,275	450	6,725
Accumulated depreciation at 1 January 20X4	386	489	125	1,000
Charge for the year	97	338	56	491
Disposals	–	(116)	–	(116)
Accumulated depreciation at 31 December 20X4	483	711	181	1,375
Carrying amount at 31 December 20X4	2,517	2,564	269	5,350
Carrying amount at 31 December 20X3	2,614	2,036	250	4,900

Required:

Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Murray Co's year-end non-current assets.

Illustration 2 – Depreciation proof-in-total

The depreciation charge for fixtures and fittings for the year ended 31 December 20X4 included in the draft financial statements of Murray Co is $338,000 (to the nearest $000).

Murray Co's depreciation policy is to depreciate fixtures and fittings using the straight-line-method. The useful economic life for fixtures and fittings is ten years.

Exercise:

Create an expectation of the fixtures and fittings depreciation charge for the year ended 31 December 20X4.

Solution

The total cost of fixtures and fittings in the draft financial statements of Murray Co is $3,275,000 (to the nearest $000).

We can set an expectation for total depreciation for fixtures and fittings for the year ended 31 December 20X4 as $3,275,000/10 = $328,000 (to the nearest $000).

The difference of $10,000 is 3% more than our expectation. If this is within an acceptable level of variation (as determined by the judgement of the auditor) the auditor will conclude that depreciation is not materially misstated.

Intangible non-current assets

Development costs

The key assertion for development costs is existence.

Sources of evidence:

- Breakdown of expenditure during the year
- Purchase invoices
- Bank statements and bank ledger account
- Timesheets
- Development expenditure/project plans
- Project test/trial results
- Cash flow forecasts
- Licence agreement
- Third-party valuation report e.g. for brand names and trademarks
- Amortisation policy and rates

Development costs should only be capitalised as an intangible asset if the recognition criteria of IAS 38 *Intangible Assets* have been met. The audit procedures suggested below focus on obtaining evidence that the treatment of the relevant item complies with these requirements.

Procedures include:

- Obtain a breakdown of capitalised costs, cast for mathematical accuracy and agree to the amount included in the financial statements **valuation**.
- For a sample of costs included in the breakdown, agree the amount to invoices or timesheets: **valuation**.
- Inspect board minutes for any discussions relating to the intended sale or use of the asset: **existence**.
- Discuss details of the project with the project manager or management to evaluate compliance with IAS 38 criteria: **existence**.
- Inspect project plans and other documentation to evaluate compliance with IAS 38 criteria: **existence**.
- Inspect budgets to confirm financial feasibility: **existence**.
- Review the financial statement disclosure in the draft financial statements to ensure compliance with IAS 38: **presentation**.

Other intangible assets

- Inspect purchase documentation for the company name and the cost of the purchased intangible assets: **existence, rights and obligations and valuation**.
- Inspect specialist valuation report and agree to the amount included in the general ledger and the financial statements: **valuation**.

Amortisation

- Inspect the budgets/forecasts for the next few years to ascertain the period over which economic benefits are expected to be generated and compare with the amortisation policy, to assess reasonableness of the amortisation period: **valuation**.
- Recalculate the amortisation charge to verify arithmetical accuracy: **accuracy, valuation**.
- For intangibles such as licences, inspect the licence agreement to confirm the amortisation period corresponds to the licence period: **valuation**.

5 Inventory

The key assertions for inventory are existence, valuation, completeness and rights and obligations.

Sources of evidence:

- Aged inventory listing
- Inventory assets
- Inventory count sheets
- Purchase invoices
- Goods received notes
- Sales invoices
- Goods despatch notes
- Client calculations of overhead allocation, absorption and apportionment and percentage of completion for work-in-progress

Inventory assets must exist, be completely recorded, be valued appropriately and must be owned or controlled by the entity.

When auditing inventory there are two main factors to consider

- Quantity of inventory – determined by the inventory count
- Valuation of the individual inventory items – usually assessed at the final audit.

ISA 501 *Audit Evidence – specific considerations for selected items* requires the auditor to:

- Attend the physical inventory count (unless impracticable), if inventory is material to the financial statements, and
- Perform procedures on the final inventory records to determine whether they accurately reflect the count results.

Inventory counts

The client must ascertain the quantity of inventory before valuing it in accordance with IAS 2 *Inventories*. To ascertain inventory quantities, the client will perform an inventory count which the auditor must attend if inventory is material to the financial statements.

The inventory count is the responsibility of the client. The auditor does not perform the count.

The auditor's attendance at the inventory count is required to:

- Evaluate management's instructions and procedures for the inventory count.
- Observe the performance of the count.

- Inspect the inventory for existence and condition.
- Perform test counts to confirm accuracy of the client's counts.

[ISA 501, 4]

There are two main methods for counting inventory:

- a full year-end count
- a perpetual inventory system

Full year-end count

A full year-end count is performed by the client to determine the quantity of inventory for inclusion in the financial statements. The count should take place on the last day of the financial year if possible. If not, it should take place as close to the year end as possible, and adjustments, referred to as a roll-back or roll-forward, will be made for goods received and despatched on the days between the year end and the date of the count. Where the count does not take place at the year end, these adjustments increase the risk of misstatement of inventory and the auditor must carefully test them.

Perpetual inventory system

A perpetual, or continuous inventory system, is one which keeps a real time track of inventory. As a sale is made, the inventory system is updated to reflect the reduction in quantity. As purchases are received, the system is updated to reflect the increase in quantity. This enables the business to know its inventory balance at any point in time.

Over time, the inventory levels stated in the perpetual inventory system may gradually diverge from actual inventory levels, due to unrecorded transactions or theft, so periodically, a count should be performed to compare system balances to actual quantities and the system can be updated accordingly.

Where the client uses a perpetual inventory system, lines of inventory are counted periodically (say monthly) throughout the year so that by the end of the year all lines have been counted.

Where the client uses this type of system the auditor should:

- Attend at least one count to ensure adequate controls are applied during the counts (in the same way as for a year-end count).
- Inspect the number and value of adjustments made as a result of the count. If significant adjustments are required after each count, this would indicate that the system figures for inventory cannot be relied upon at the year end and a full count will be required.
- If the system balance for inventory is deemed reliable as a result of these procedures, further procedures to verify valuation and rights will still be required.

Advantages of perpetual counts

- Reduces time constraints for the auditor, and enables them to attend counts relating to lines at greater risk of material misstatement.
- Slow-moving and damaged inventory is identified and adjusted for in the client's records on a continuous basis meaning the year-end valuation should be more accurate.

Disadvantages of perpetual counts

- The auditor will need to obtain sufficient appropriate evidence that the system operates effectively at all times, not just at the time of the counts they attend.
- Additional procedures will be necessary to ensure that the amount included for inventory in the financial statements is appropriate, particularly with regard to cut-off and year-end allowances.

Controls over the count(s)

It is important for the count(s) to be performed effectively to ensure inventory quantities are accurately ascertained. Adequate controls must be implemented such as:

- Segregation of duties by having the count performed by non-warehouse staff.
- No movement of inventory while the count takes place.
- A system for allocating inventory to counting teams to ensure all inventory is counted but not duplicated.
- A system for identifying inventory which should not be valued at cost.
- A system to ensure inventory belonging to third parties is not included in the count.
- A system to ensure that any inventory stored elsewhere is counted and included in the company's count records.

Additional considerations at the inventory count(s)

Cut-off procedures

The inventory count(s) will be affected by goods despatched and goods received.

During the count, inventory movements should preferably stop to enable the count to be conducted without being affected by deliveries.

For some organisations this won't be possible as they may operate production and deliveries 24 hours a day.

In these types of organisations, the client should move the items requiring despatch to a different location to that being counted prior to the count taking place. Any deliveries of goods should be made to a different location while the count is ongoing to enable the count to be conducted without movement of items.

A separate count can then be performed on the items delivered during the count and these can be added to the warehouse items counted.

By having such controls in place, the completeness and existence of inventory at the count date can be verified as well as the cut-off assertion for purchases and sales.

Third-party inventory stored at the client

If the client stores inventory on behalf of a third party, they should have procedures in place to ensure this inventory is not included in their own records. During the inventory count(s) the inventory belonging to a third party must be separately identifiable, and preferably moved to different location, to minimise the risk of it being counted as part of the client's inventory which would overstate the inventory balance in the financial statements.

Inventory stored at a third party

Some clients will not have space to store all of their inventory and may use a third-party storage facility. The inventory held at a third-party site still needs to be counted and included in the client's inventory records. The auditor will need to obtain sufficient appropriate audit evidence that the inventory actually exists and belongs to the client.

Procedures include:

- Where a third party holds inventory on behalf of the client, obtain external confirmation from the third party of the quantity and condition of the goods to confirm rights and valuation.
- If inventory held by the third party is material, the auditor should visit the site to verify existence of the inventory.
- The auditor can also obtain a report from the third-party's auditors confirming the reliability of the internal controls at the third party.

Audit procedures on the final inventory records

At the final audit, the auditor will need to perform audit procedures over the assertions such as cut-off, valuation, rights and obligations, classification and presentation.

Procedures will need to be appropriately designed for the type of inventory e.g. raw materials, work-in-progress, and finished goods.

If a client uses a standard costing system rather than actual costs, additional procedures will need to be performed.

Typical audit procedures performed at the final audit

- Inspect GRNs and GDNs around the year end to confirm correct cut-off. Goods received before the year end should be traced through to inclusion in the inventory listing whilst goods received after the year end should not be included. Similarly, goods despatched before the year end should not be included within inventory whereas goods despatched post year end should be included in the year-end inventory balance.
- Review purchase invoices and post-year-end sales invoices to ascertain if net realisable value (NRV) is above cost or if an adjustment is required.
- Calculate and compare the inventory holding period with prior year to identify slow-moving inventory which needs to be written down to the lower of cost and net realisable value.
- Inspect purchase invoices for the name of the client to confirm rights and obligations.
- Review the disclosures in the financial statements to ensure compliance with applicable financial reporting framework e.g. carrying amount of inventory by category such as raw materials, work-in-progress and finished goods, accounting policies used, details of any write-downs during the year.

Work-in-progress (WIP)

- Obtain a schedule itemising the jobs included in WIP at the year end, cast it and agree the total to the general ledger and draft financial statements.
- Agree a sample of items from the schedule to the inventory count records to confirm existence.
- Agree costs to supporting documentation such as supplier's invoice and payroll records.
- For overheads absorbed into the WIP valuation, discuss the absorption method used with management and assess its reasonableness.
- Discuss with the production manager how the percentage of completion has been determined at the year end and agree the stage of completion to the inventory count records.
- Confirm that net realisable value is greater than cost by comparing the contract price with the WIP value plus costs to complete.
- To assess the completeness of WIP, select a sample of customer orders and trace through to the list of jobs included in the WIP schedule.

Standard costs

Standard costs are often used by manufacturing companies where it would be too time-consuming to collect actual cost information for each individual unit produced. The company establishes an expected cost of producing one item based on a normal level of activity. This is used to value the inventory.

Any difference between actual cost and standard cost is taken to a variance account in the statement of profit or loss. A large variance on the variance account would indicate that the standard costs are not a close approximation of the actual costs and therefore the inventory valuation will not be reliable.

Standard costs are more likely to be reliable if they are updated on a regular basis. How frequently the standard costs should be updated will depend on how often the cost of components used in the manufacturing process changes.

Audit procedures must be performed to assess the reasonableness of the standard costs as a means of valuing inventory, including:

- Obtain the breakdown of the standard cost calculation and agree a sample of costs to invoices.
- Enquire of management the basis for the standard costs and how often they are updated to reflect current costs.
- Inspect the variance account and assess the level of variance for reasonableness. Discuss with management any significant variances arising.

Test your understanding 3 – Inventory

Murray Co's inventory count instructions are as follows:

1. A finance manager must supervise the inventory count.
2. No goods are to be received or despatched during the inventory count.
3. Each team will consist of two members of staff from the finance department. One person must count the items. The second person will record the count on sequentially numbered count sheets.
4. The teams will be allocated a team number and will be provided with a map of the warehouse. Each area of the warehouse is marked on the map with the number of the team that is to count inventory in that area. The warehouse manager will be in attendance to ensure each team is clear about which area they are counting, before it is counted.
5. Once a section is counted it must be tagged to confirm it has been counted. Yellow tags are to be used by the first counting team to confirm the count has been performed.

6 Once the first count is complete, a second count will take place, with each team counting an area that they were not responsible for on the first count (according to the warehouse map). Any discrepancies should be notified to the finance director immediately. Green tags are to be used to confirm the count has been checked by a second team.

7 Sequentially numbered count sheets will contain the product description from the inventory system but no system quantities.

8 Any items of inventory in the warehouse that are not listed on the count sheets should be recorded on a blank, sequentially numbered count sheet.

9 Inventory count sheets must be recorded in ink. If a mistake is made, it should be crossed out neatly and the correct information written next to it.

10 Any damaged or obsolete items will be moved to a designated area. After the count, an assessment of the goods will be made by the finance manager with advice from a sales manager and the warehouse manager, to determine the allowance appropriate for the condition of the items.

11 After the count, the finance manager should review the warehouse to ensure all sections have been tagged with both yellow and green tags to confirm the count is complete.

12 The count sheets must be signed by each team member responsible for completing the sheets and returned to the finance manager who will perform a sequence check to confirm all count sheets have been returned.

13 The finance manager will compare the inventory count sheets to the inventory records and any adjustments will be updated by another finance manager not involved in the count.

Required:

(a) Describe the procedures that should be performed by the auditor before attending the inventory count of Murray Co.

(b) Describe the audit procedures that should be performed whilst in attendance at the inventory count of Murray Co.

(c) Describe the substantive procedures that should be performed during the final audit of Murray Co.

6 Receivables

The focus of testing for receivables is valuation and existence.

Sources of evidence:

- Aged listing of individual customers
- Sales invoices
- Goods despatch notes
- Receivables circularisation letters
- Post-year-end bank statements
- Policy for allowance for doubtful receivables

The receivables balance included in the financial statements must exist and be included at the appropriate amount.

Receivables will be overstated if irrecoverable receivables have not been written off or doubtful receivables have not been written down. Audit procedures will therefore obtain evidence regarding the recoverability of amounts outstanding at the year end.

Third-party evidence will be obtained in the form of a receivables circularisation letter which will confirm existence of amounts outstanding at the year end.

Receivables circularisations
The auditor will send a circularisation letter to a sample of customers asking them to confirm the balance owed to the client at the year end. This is considered to be a reliable source of evidence for certain financial statement assertions, such as existence, because it is documentary evidence sent directly to the auditor from an external source. They will not be reliable evidence for the valuation assertion as the customer only confirms the transaction price and does not have to state any intention to pay the invoice. Circularisation letters can be positive or negative. **A positive receivables circularisation** requires customers to respond to the auditor's request for information. The auditor can include the balance per the client's records and ask the customer to reply stating whether or not the balance is correct. Alternatively, the auditor can ask the customer to respond by stating the balance they believe they owe the client, but the auditor does not provide the balance per the client's records to the customer. A **negative receivables circularisation** requests customers to respond only if they disagree with the balance provided by the auditor. This is only suitable if the risk of material misstatement is low as the customer may confirm an incorrect balance if it is in their favour.

Steps in undertaking a positive receivables circularisation

- Obtain consent from the client to perform the circularisation.
- Obtain a list of individual customers with balances outstanding at the year end, cast this and agree it to the trade receivables account.
- Select a sample from the receivables list ensuring that a number of nil, old, credit and large balances are selected.
- Circularisation letters should be prepared on the client's letterhead paper, requesting a confirmation of the year-end receivables balance, and for replies to be sent directly to the auditor's office using a pre-paid envelope.
- An appropriate member of client staff, such as the finance director, should be requested to sign all the letters prior to them being sent out by a member of the audit team.
- Where no response is received, follow this up with another letter or a phone call and where necessary alternative procedures should be performed such as after-date cash testing and inspection of sales invoices and GDNs relating to the receivable.
- When replies are received, they should be reconciled to the client's receivables records, and any differences such as cash or goods in transit should be investigated further.

ISA 505 External Confirmations

ISA 505 *External Confirmations* requires the auditor to maintain control over external confirmation requests when using external confirmations as a source of audit evidence.

This can be achieved by the auditor:

- Preparing the confirmation letters, determining the information to be requested and the information that should be included in the request.
- Selecting the sample of external parties from which to obtain confirmation.
- Sending the requests to the confirming party.

[ISA 505, 7]

e.g

Illustration 3 – Murray Co positive confirmation letter

Customer Co

Customer's address

7 January 20X5

Dear Sirs

As part of their normal audit procedures we have been requested by our auditors, Wimble & Co, to ask you to confirm the balance on your account with us at 31 December 20X4, our year end.

The balance on your account, as shown by our records, is shown below. After comparing this with your records will you please be kind enough to sign the confirmation and return a copy to the auditor in the prepaid envelope enclosed. If the balance is not in agreement with your records, will you please note the items making up the difference in the space provided.

Please note that this request is made for audit purposes only and has no further significance.

Your kind co-operation in this matter will be greatly appreciated.

Yours faithfully

Chief Accountant

Murray Co

Wimble & Co address

Dear Sirs

We confirm that, except as noted below *, a balance of $XX was owing by us to Murray & Co at 31 December 20X4.

(space for customer's signature)

* Details of differences

"7 January 20X5": The confirmation letter should be **sent as soon as possible after the year end,** to increase the chance of an accurate and timely response.

"As part of their normal audit procedures, we have been requested by our auditors to confirm the balance on your account with us at 31 December 20X4... please be kind enough to sign the confirmation and return a copy to the auditor...": It is the **client** who **writes to their customers** requesting the information but the **response** must be sent directly to the auditors to reduce the risk of the client interfering with any response.

"...in the prepaid envelope enclosed": Making it as easy as possible to respond increases the chance that sufficient customers will confirm balances for it to be a valid audit test.

"If the balance is not in agreement with your records, will you please note the items making up the difference in the space provided": Requesting the customer to complete the reconciliation increases the reliance the auditor can place on this evidence (although the auditor will review the reconciliation and investigate any unreconciled differences or disagreements).

Prepayments

Prepayments are services or goods which a company has paid for in advance. The client should include the value of any prepayments as a receivable in the financial statements.

- Inspect bank statements and bank ledger account to ensure payment has been made before the year end: **existence**.
- Inspect invoices to ensure payment relates to goods or services not yet received: **existence**.
- Recalculate the amount prepaid to confirm mathematical accuracy: **valuation**.
- Compare prepayments with the prior year to identify any missing items or any new prepayments which require further testing: **existence, valuation, and completeness**. **(Analytical procedure)**.

Test your understanding 4 – Receivables

Murray Co

Aged receivables analysis at 31 December 20X4 ($000)

Ref	Customer Name	Total	Current	30–60 days	60–90 days	90–120 days	120 days
A001	Anfield United Shop	**176**	95	76	5	0	0
B001	Bibs and Balls	**0**	0	(24)	0	24	0
B002	The Beautiful Game	**84**	62	0	20	0	2
B003	Beckham's	**42**	32	10	0	0	0
C001	Cheryl & Coleen Co	**12**	12	0	0	0	0
D001	Dream Team	**45**	0	31	14	0	0
E001	Escot Supermarket	**235**	97	65	0	0	73
G001	Golf is Us	**211**	0	0	0	100	111
G002	Green Grass	**61**	50	11	0	0	0
H001	HHA Sports	**59**	40	0	19	0	0
J001	Jilberts	**21**	11	10	0	0	0
J002	James Smit Partnership	**256**	73	102	34	45	2
J003	Jockeys	**419**	278	120	21	0	0
O001	The Oval	**92**	48	44	0	0	0
P001	Pole Vaulters	**76**	0	0	76	0	0
P002	Polo	**0**	0	0	0	0	0
S001	Stayrose Supermarket	**97**	24	23	23	27	0
T001	Trainers and More	**93**	73	20	0	0	0
T002	Tike Co	**(54)**	0	0	0	0	(54)
W001	Wanderers	**89**	60	29	0	0	0
W002	Whistlers	**(9)**	645	(654)	0	0	0
W003	Walk Hike Run	**4**	0	0	0	0	4
W004	Winners	**31**	21	10	0	0	0
Total		**2,040**	**1,621**	**(127)**	**212**	**196**	**138**

Required:

(a) Identify, with reasons, FOUR trade receivables balances from the aged receivables analysis that should be selected for further testing.

(b) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Murray Co's trade receivables.

7 Payables and accruals

The focus of testing for liabilities is completeness.

Sources of evidence:

- Aged listing of individual suppliers
- Purchase invoices
- Goods received notes
- Post-year-end bank statements
- Supplier statements
- Supplier circularisations (where supplier statements are not available)

The payables balance included in the financial statements must be complete.

Payables will be understated if all liabilities in relation to purchases made have not been recorded.

Third-party evidence will be obtained in the form of supplier statements and supplier circularisation letters.

Trade payables

Procedures include:

- Obtain a list of individual suppliers at the year end, cast to verify arithmetical accuracy and agree to the general ledger and the financial statements: **completeness, classification, presentation**.
- Reconcile the total of the list of individual suppliers with the trade payables account: **completeness**.
- Obtain supplier statements and reconcile these to the list of individual supplier balances. Investigate any reconciling items: **existence, completeness, obligations and valuation**.
  Note: Supplier statement reconciliations provide the most reliable evidence in respect of payables as they provide external confirmation of the balance.

- Inspect after-date payments, if they relate to the current year then follow through to the individual supplier's account or accruals listing: **completeness**.
- Inspect invoices received after the year end in respect of goods delivered before the year end and trace through to the accruals listing: **completeness**.
- Enquire of management their process for identifying goods received but not invoiced and ensure that it is reasonable: **completeness**.
- Select a sample of goods received notes immediately before the year end and follow through to inclusion in the year-end individual supplier's account or accruals listing: **completeness of payables** and **cut-off of purchases**.
- Select a sample of payable balances and perform a trade payables' circularisation, follow up any non-replies and any reconciling items between the balance confirmed and individual supplier's account: **completeness** and **existence**.
- Inspect the list of individual suppliers for any debit balances or any significant amounts and discuss with management. Consider reclassification as current assets: **valuation** of payables and **completeness of receivables, classification**.
- Compare the list of individual suppliers and accruals against the prior year list to identify any significant omissions: **completeness**. **(Analytical procedure)**
- Calculate the trade payables payment period and compare to prior year, investigate any significant differences: **completeness** and **valuation**. **(Analytical procedure)**

Accruals

Procedures include:

- Obtain the list of accruals from the client, cast it to confirm mathematical accuracy and agree to the general ledger and the financial statements: **completeness, classification**.
- Recalculate a sample of accrued costs by reference to contracts and payment schedules (e.g. loan interest): **valuation** (**accuracy** of purchases and other expenses).
- Inspect invoices received post year end to confirm the actual amount and assess whether the accrual is reasonable: **valuation**.
- Compare the accruals this year to last year to identify any missing items or unusual fluctuation in amount and discuss this with management: **completeness and valuation**. **(Analytical procedure)**

Test your understanding 5 – Payables

Murray Co's trade payables balance at 31 December 20X4 is $1,400,000 (to the nearest $000). The total balance has already been agreed to the trade payables account which shows that trade payables consists of fifteen suppliers.

A junior member of the audit team has been testing five of these balances by reconciling supplier statements to the balances on the list of individual suppliers. They have been unable to reconcile a material balance, relating to Racket Co, which supplies material to Murray Co, for stringing tennis rackets. You have been asked for advice on the audit work which should be carried out on the differences.

The balance of Racket Co on Murray Co's purchase ledger is shown below:

Individual supplier account: Racket Co

Date	Type	Reference	Status	Dr ($)	Cr ($)	Balance ($)
10.10	Invoice	6004	Paid 1		21,300	
18.10	Invoice	6042	Paid 1		15,250	
23.10	Invoice	6057	Paid 1		26,340	
04.11	Invoice	6080	Paid 2		35,720	
15.11	Invoice	6107	Paid 2		16,320	
26.11	Invoice	6154	Paid 2		9,240	
30.11	Payment	Cheque	Alloc 1	61,630		
	Discount		Alloc 1	1,260		
14.12	Invoice	6285			21,560	
21.12	Invoice	6328			38,240	
31.12	Payment	Cheque	Alloc 2	60,050		
	Discount		Alloc 2	1,230		
31.12	**Balance**					**59,800**

Racket Co has sent the following supplier statement:

Date	Type	Reference	Status	Dr ($)	Cr ($)	Balance ($)
07.10	Invoice	6004		21,300		
16.10	Invoice	6042		15,250		
22.10	Invoice	6057		26,340		
02.11	Invoice	6080		37,520		
13.11	Invoice	6107		16,320		
22.11	Invoice	6154		9,240		
10.12	Receipt	Cheque			61,630	
04.12	Invoice	6210		47,350		
12.12	Invoice	6285		21,560		
18.12	Invoice	6328		38,240		
28.12	Invoice	6355		62,980		
31.12	**Balance**					**234,470**

Racket Co's terms of trade with Murray Co allow a 2% cash discount on invoices where Racket Co receives payment from the customer by the end of the month following the date of the invoice (i.e. a 2% discount will be given on November invoices paid by 31 December).

Under 'Status', the cash and discount marked 'Alloc 1' relate to the invoices marked 'Paid 1' (similarly for 'Alloc 2' and 'Paid 2').

Murray Co's goods received department checks the goods when they arrive and issues a goods received note (GRN). A copy of the GRN and the supplier's advice note is sent to the purchases accounting department.

Required:

(a) Prepare a statement reconciling the balance on Murray Co's individual supplier account to the balance on Racket Co's supplier's statement.

(b) Describe the audit work you will carry out on each of the reconciling items you have determined in your answer to part (a) above, in order to determine the balance which should be included in the financial statements.

8 Provisions and contingencies

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to recognise a provision if:

- a present obligation has arisen as a result of a past event
- payment is probable ('more likely than not'), and
- the amount can be estimated reliably.

If payment is only possible, a contingent liability must be disclosed in the notes to the financial statements.

A contingent asset can only be recognised if it is virtually certain to be received. If it is probable that an inflow of economic benefits will result, a disclosure should be made in the financial statements. If it is only possible, it should be ignored.

Provisions and contingent liabilities

Audit testing will focus on whether an obligation exists, whether payment is probable or possible, and whether the provision is valued appropriately.

Completeness is a key assertion as the company may understate liabilities to improve its financial position.

Contingent assets

Audit testing will focus on whether payment is virtually certain or probable, and whether the receivable is valued appropriately.

Existence is a key assertion as the company may overstate contingent assets to improve its financial position.

Examples of contingent assets include:

- Amounts due to be received from an insurance claim
- Amounts due to be received in respect of a legal claim
- Amounts due to be received from a liquidator in respect of an investment or bankrupt receivable.

Provisions and contingent liabilities

Procedures include:

- Obtain a breakdown of provisions, cast it and agree the figure to the financial statements: **accuracy** and **presentation**.
- Enquire with the directors, or inspect relevant supporting documentation, to confirm that a present obligation exists at the year end: **rights and obligations**.
- Inspect relevant board minutes to ascertain whether payment is probable: **existence**.

- Recalculate the liability and agree components of the calculation to supporting documentation: **completeness**.
- Inspect post-year-end bank statements to identify whether any payments have been made, compare actual payments to the amounts provided to assess whether the provision is reasonable: **valuation**.
- Review the financial statement disclosure of the provisions and contingent liabilities to ensure compliance with IAS 37: **presentation**.
- Obtain a written representation from management that they believe the provisions and contingent liabilities are treated appropriately in the financial statements, are valued appropriately and are complete: **valuation** and **completeness**.

e.g

Illustration 4 – Murray Co provisions

The statement of financial position shows that Murray Co has a provision liability of $240,000 for the year ended 31 December 20X4. The majority of the balance relates to provisions for warranties ($200,000). $40,000 of the provision relates to a claim made by an ex-employee of Murray Co who is claiming for unfair dismissal.

The audit plan includes the following audit procedures in relation to these provisions:

Warranty provision procedures

- Obtain a breakdown of the warranty provision and recalculate to verify arithmetical accuracy.
- Enquire of management the basis used for the provision and assess whether this is reasonable.
- Compare previous year actual warranty costs with the amount provided to assess whether management's process is reasonable.
- Compare warranty claims post year end to the warranty provision at the year end to assess whether the provision is adequate.
- Review product returns and complaints to assess whether there is a need for a higher provision than in previous years.
- Calculate warranty costs/revenue and compare with prior year to assess whether the level of provision is consistent with the prior year. Discuss any change in proportion with management.

Legal provision procedures

- Enquire with the directors when the employee was dismissed to confirm that a present obligation exists at the year end.
- Inspect correspondence between the employee and Murray to verify that the employee was dismissed before the year end.

- Inspect relevant board minutes to ascertain whether it is probable that the payment will be made to the employee.
- Obtain confirmation from Murray's lawyer about the likely outcome and probability of payment.
- Inspect correspondence received from the lawyer regarding the legal provision to assess whether a provision should be recognised and if so, whether the amount of the provision is adequate.
- Obtain a breakdown of the costs to be provided and recalculate to ensure completeness.
- Agree the components of the calculation to supporting documentation, e.g. fee estimate from Murray Co's lawyer, claim received from the ex-employee.
- Inspect post-year-end bank statements to identify whether any payments have been made and compare actual payments to the amounts provided to assess whether the provision is reasonable.

Procedures relevant to both provisions

- Obtain a written representation from management to confirm the adequacy and reasonableness of the provisions.
- Review the financial statement disclosure to ensure compliance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Contingent assets

Procedures include:

- Review correspondence from third parties (lawyer, insurance company, insolvency practitioner) regarding the value likely to be received and probability of payment. Agree the figure into the disclosure note relating to the contingent asset: **existence, accuracy & valuation and presentation**.
- Review correspondence from third parties (court, insurance company, insolvency practitioner) confirming the amount awarded to the client. Agree the figure to other receivables and other income within the financial statements: **accuracy & valuation, existence, rights & obligations, and presentation**.
- Review post-year-end bank statements and bank ledger account to confirm the amount received: **accuracy & valuation, existence, rights & obligations, and presentation**.

ISA 501 *Audit Evidence – special considerations for selected items*
ISA 501 requires the auditor to design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Procedures include enquiring of management, reviewing meeting minutes and reviewing legal expense accounts. [ISA 501, 9]

9 Accounting estimates

There are many accounting estimates in the financial statements, e.g. allowances for receivables, depreciation of property, plant and equipment, provisions, etc.

Accounting estimates are inherently risky because they relate to the future and therefore documentary evidence may be limited. This makes it difficult for the auditor to obtain sufficient appropriate evidence regarding the balance.

Inherent risk is increased because management judgement is needed to determine accounting estimates. As a result, estimates may be used to manipulate the financial statements and show a desired result.

Professional scepticism is essential for the auditor to ensure the accounting estimates are reasonable and are not being used to introduce bias into the financial statements.

ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* requires the auditor to obtain an understanding necessary to allow the auditor to identify and assess the risks of material misstatement relating to accounting estimates. [13]

This involves obtaining an understanding of:

- The entity's environment including the requirements of the financial reporting framework and regulatory factors relevant to accounting estimates. [13b, c]
- The entity's internal controls related to accounting estimates including the control activities, the need for specialised skills, and the governance in place over the financial reporting process relevant to estimates, and how management reviews the outcome of previous accounting estimates and responds to the results of the review. [13e, f, j]

The auditor must separately assess inherent risk and control risk when assessing the risk of material misstatement relating to accounting estimates. When assessing inherent risk, the auditor should consider:

- The degree to which the estimate is subject to estimation uncertainty.
- The degree of complexity and subjectivity involved in the method, assumptions and data used to make the estimate.
- The degree of complexity and subjectivity used in the selection of management's point estimate. [16]

When responding to the risk of material misstatement in the accounting estimates, the auditor must perform the following procedures:

- Obtain evidence from subsequent events.
- Test how management made the estimate.
- Develop an auditor's point estimate or range. [18]

10 Share capital, reserves and director's remuneration

Each of these areas are material by nature.

Share capital

Sources of evidence:

- Share register
- Share certificates
- Bank statements and bank ledger account
- Board minutes
- Registrar of companies (e.g. Companies House)

Procedures include:

- Agree authorised share capital and face value disclosures to underlying shareholding agreements/statutory constitution documents.
- Inspect bank ledger account for evidence of cash receipts from share issues and ensure amounts not yet received are correctly disclosed as share capital called-up not paid in the financial statements.
- Inspect board minutes to verify the amount of share capital issued during the year.

Dividends

Sources of evidence:

- Board minutes
- Bank statements and bank ledger account
- Dividend warrant

Procedures include:

- Inspect board minutes to agree dividends declared before the year end.
- Inspect bank statements to agree dividends paid before the year end.
- Inspect dividend warrants to agree dividend payment.

Directors' emoluments

Sources of evidence:

- Directors' service contracts
- Board minutes
- Bank statements and bank ledger account
- Payroll records
- Written representation from management

Procedures include:

- Obtain and cast a schedule of directors' remuneration split between wages, bonuses, benefits, pension contributions and other remuneration, and agree to the financial statement disclosures.
- Inspect payroll records and agree the figures disclosed for wages, bonuses, and pension contributions.
- Inspect bank statements to verify the amounts actually paid to directors.
- Inspect board minutes for discussion and approval of directors' bonus announcements or other additional remuneration.
- Obtain a written representation from directors that they have disclosed all directors' remuneration to the auditor.

Reserves

- Agree opening reserves to prior year closing reserves and reconcile movements.
- Agree movements in reserves to supporting documentation (e.g. revaluation surplus movements to the independent valuer's report).

11 Statement of profit or loss

Due to the volume of transactions processed during the year, most companies will have controls in place over revenue, purchases and payroll. The auditor will therefore seek to place reliance on internal controls over these areas.

Substantive procedures will still need to be performed as these areas will be material to the financial statements and the auditor is likely to perform **substantive analytical procedures** as an efficient way of obtaining substantive audit evidence where controls are working effectively.

Some specific tests of detail will be performed when testing the statement of profit or loss items. In addition, some evidence will be obtained over revenue and purchases indirectly through the direct tests performed on the corresponding receivables and payables in the statement of financial position (directional testing).

Payroll

The focus of testing for payroll is completeness, accuracy and occurrence.

Sources of evidence:

- Payroll account
- Payroll payment listing
- Payslips
- Contracts of employment
- Hourly rates of pay
- Timesheets
- Bank statements and bank ledger account
- Starters and leavers forms

Payroll will be understated if all employees who should have been paid have not been paid.

Payroll will be overstated if fictitious employees, or employees who no longer work for the entity, are paid.

Payroll will be misstated if errors are made in the payroll calculations.

Procedures include:

- Agree the total wages and salaries expense per the payroll account to the general ledger and the financial statements: **completeness and presentation**.
- Cast the monthly payroll listings to verify the accuracy of the payroll expense: **accuracy**.
- Recalculate the gross and net pay for a sample of employees and agree to the payroll records: **accuracy**.
- Recalculate statutory deductions to confirm whether correct deductions for this year have been included within the payroll expense: **accuracy**.
- Select a sample of joiners and leavers, agree their start/leaving date to supporting documentation, recalculate that their first/last pay packet was accurately calculated and recorded: **completeness, occurrence, accuracy**.
- For salaries, agree the total net pay per the payroll records to the bank transfer listing of payments and to the bank ledger account/cash book: **occurrence**.
- For cash wages, agree that the total cash withdrawn for wage payments equates to the weekly wages paid plus any surplus cash subsequently banked: **completeness, occurrence**.
- Agree the year-end tax liability to the payroll records and subsequent payment to the post-year-end bank ledger account: **occurrence**.
- For a sample of individuals, agree the amount per the payroll listing to the personnel records, and timesheets if applicable: **accuracy**.

Analytical procedures

- Perform a proof in total of total wages and salaries incorporating joiners and leavers and any pay increase awarded during the year. Compare this to the actual wages and salaries in the financial statements and investigate any significant differences: **completeness, accuracy**.
- Compare the payroll figure for this year to last year to identify any unusual fluctuations and discuss them with management: **completeness, accuracy**.

e.g

Illustration 5 – Murray Co payroll proof in total

Total payroll for the year ending 31 December 20X3 was $1,220,000 (to the nearest $000). At this time Murray Co had 34 employees.

Total payroll for the year ending 31 December 20X4 is $1,312,000 (to the nearest $000). Murray Co now has 37 employees.

All employees received a 5% pay rise on 31 March 20X4.

Exercise:

Create an expectation of the total payroll cost for year ended 31 December 20X4.

Solution

The average salary per employee in 20X3 was $35,882 ($1,220,000/34).

All employees received a 5% pay rise in March. The average value of this pay rise is therefore $1,346 per employee in 20X4 (5% × 9/12 × $35,882). The average salary for 20X4 is $37,228 ($35,882 + $1,346), therefore the **expectation for total payroll for the year ending 31 December 20X4** is **$1,377,000** (37 × $37,228) to the nearest $000.

The difference ($65,000) is less than 5% more than our expectation. If this is within an acceptable level of variation (as determined by the judgement of the auditor) the auditor will conclude that the payroll cost is not materially misstated.

Revenue

The focus of testing for revenue is completeness, cut-off, occurrence and accuracy.

Sources of evidence:

- Revenue account
- Detailed sales listing/sales day book
- Sales invoices
- Customer contracts
- Goods despatch notes
- Sales orders

Revenue will be understated if all sales transactions are not recorded.

Revenue will be overstated if fictitious sales, or sales which have been returned, are recorded.

Revenue will be misstated if errors are made in the sales invoice calculations.

Procedures include:

- Inspect a sample of GDNs before and after the year end and ensure they have been recorded in the detailed sales listing in the correct period: **cut-off**.
  In most cases, the despatch of goods indicates that the seller has fulfilled its performance obligations and therefore the sale can be recorded.
- Recalculate discounts and sales tax applied for a sample of large sales invoices: **accuracy**.
- Select a sample of customer orders and agree these to the despatch notes and sales invoices through to inclusion in the detailed sales listing: **completeness**.
- Inspect credit notes issued after the year end, trace to GDN and invoice and ensure the sale has been reversed: **occurrence**.

Analytical procedures

- Compare revenue against prior year and investigate any significant fluctuations: **cut-off, occurrence, accuracy and completeness**.
- Compare revenue with budget/forecast and investigate any significant fluctuations: **cut-off, occurrence, accuracy and completeness**.
- Calculate the gross profit margin and compare to prior year. Investigate any significant differences: **cut-off, occurrence, accuracy and completeness**.